

Articles

OF COMPLICITY AND COMPLIANCE: A RULES-BASED ANTI-COMPLICITY STRATEGY UNDER FEDERAL SECURITIES LAW

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ABSTRACT

Most policy analyses aimed at deterring complicity in securities law violations implicitly assume that a standards-based regime (such as liability standards for aiding and abetting) represents the best strategy for accomplishing that objective. Moreover, many commentators regard the restoration of private damage remedies against complicit secondary actors as essential to the success of any anti-complicity regime. These concerns are linked to the Supreme Court's Central Bank trilogy—Central Bank, Stoneridge Investment Partners, and Janus Capital Group—decisions that mechanically constrain a principled understanding of the relationship between primary and secondary liability standards. This article offers a fundamentally different policy approach in thinking about the problem of complicity in securities violations. It uses the concept of anti-complicity policies—i.e., policies designed to deter secondary participants from providing assistance to, or to make such participants accountable in monitoring or preventing, more fundamental forms of misconduct—as a rubric to compare the effectiveness of two different classes of strategies: standards-based policies and rules-based policies. The article then argues that enforcement objectives would be better served by refocusing anti-complicity policies on a rules-based regime. First, a rules-based regime may be more effective in a wide variety of contexts than a standards-based

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regime. Second, while a rules-based regime is not inconsistent with private liability for aiding and abetting, the combination of publicly-enforced standards and robust anti-complicity rules may be more socially efficient than a regime that relies almost exclusively on public sanctions and private remedies for aiding and abetting. Third, a rules-based regime (even if not explicitly conceived of as such) has already begun taking shape within federal securities law on an ad hoc basis that gives some sense of the potential feasibility of a more robust rules-based approach. This article acknowledges two significant caveats. It does not recommend eliminating anti-complicity standards (such as aiding and abetting principles) because such standards provide a powerful and necessary backstop to the inevitable gaps and interstices of a rules-based regime. Furthermore, the article does not argue that the emerging use of rules-based strategies has produced a fully adequate anti-complicity regime. Instead, the article urges continued movement toward a more robust rules-based anti-complicity regime, a result that at a minimum would require a much broader grant of rulemaking authority to the SEC.

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INTRODUCTION

Legal strategies designed to curb complicit assistance to another person engaged in unlawful conduct have a critical role in deterring securities law violations, especially securities fraud. Under federal law, aiding and abetting standards are the most prominent example of such principles, and in recent years the concept of aiding and abetting liability has been the focal point for significant legislative and judicial policy skirmishes. Most notably, in *Central Bank v. First Interstate Bank*,¹ the Supreme Court revoked the longstanding judicial recognition of private rights of action for aiding and abetting under Rule 10b-5. The decision represents a watershed in judicial thinking about complicity under federal securities law. In two subsequent decisions involving private securities actions, the Supreme Court further limited the liability of secondary actors whose conduct arguably rose to the level of primary liability. In *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*,² the Court held that *Central Bank*'s prohibition on private rights of action for aiding and abetting extended even to actions against secondary participants who engaged in acts of fraud in furtherance of a fraudulent scheme.³ In its most recent term, the Supreme Court went even further, holding that secondary parties are immune from private damages actions under the *Central Bank* principle, even if they draft fraudulent disclosures disseminated to investors relating to matters within the secondary party's exclusive knowledge, provided the statements are never specifically attributed to the secondary party, and another party retained ultimate authority over the decision to release the statements.⁴

Legislatively, Congress has declined to restore private actions against parties based on complicity,⁵ but has consistently acted to extend aiding and abetting liability in SEC enforcement actions.⁶ Following *Central Bank*, the Private Securities Litigation Reform Act of 1995⁷ (the "PSLRA")

1. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

2. *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

3. *Id.* at 159–61.

4. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011). While limiting primary liability for secondary actors and thus any liability for damages to injured investors, the decision did not purport to foreclose the secondary actor's liability for complicity in SEC law enforcement actions, provided a claim for primary liability remained viable against one or more other actors.

5. *See infra* note 191 and accompanying text (noting Congress's failure to restore such implied private cause of action, along with Section 20(e) of the Exchange Act's instructiveness on this decision).

6. *See infra* Section III.A (discussing the evolution of federal securities law in terms of anti-complicity standards, and the SEC's current enforcement power thereunder).

7. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737

restored the SEC's ability to seek sanctions against aiders and abettors in civil actions, a legislative judgment that *Central Bank* had gone too far in casting doubt on such liability in law enforcement actions. In the Dodd-Frank Act,⁸ Congress made explicit that in civil enforcement actions, a lower scienter standard based on recklessness was appropriate for establishing aiding and abetting liability.⁹

While these twists and turns offer opportunity for debate and indeed have been much debated,¹⁰ an unarticulated assumption in these discussions is the centrality (and even exclusive utility) of aiding and abetting standards in regulating complicity under federal securities law. This article challenges that assumption. Instead of asking how aiding and abetting principles might be better refined or whether the remedies and sanctions for aiding and abetting liability should be reconfigured, this article explores the more fundamental question of whether there are more effective strategies for deterring complicity than primarily relying on a standards-based regime built around aiding and abetting standards. This article does not advocate doing away with aiding and abetting standards, but rather urges the adoption of rules-based strategies as the primary focus for anti-complicity policy.

In order to make the case for greater reliance on rules-based strategies, I will make various references to anti-complicity policies, strategies, principles, and measures. While aiding and abetting standards are easily the most discussed forms of anti-complicity measure, in fact, there exists a vast range of measures properly viewed as anti-complicity devices. As I am using the term, anti-complicity policies refer to regulatory features that expand the zone of unlawful behavior for secondary actors in providing assistance to others engaged in securities law violations. Expanding the zone of a secondary party's legal obligations makes it more likely that the secondary party will act in ways that impede the primary actor's ability to engage in more fundamental securities law violations.¹¹ In this sense, anti-

(1995) (codified as amended at 15 U.S.C. §§ 77–78(2006)) [hereinafter PSLRA].

8. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act]; see *infra* Section II.A.2 (describing these changes).

9. See *infra* Section III.C (examining further this lower scienter standard).

10. See generally U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-664, SECURITIES FRAUD LIABILITY OF SECONDARY ACTORS (2011) (summarizing the history and conflicting policy proposals relating to secondary liability for securities fraud).

11. This vaguely echoes Professor Kraakman, who broadly defined gatekeepers as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers.” Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986). While gatekeeping undoubtedly represents an anti-complicity mechanism, anti-complicity policies encompass a broader range of policies directed at persons whose cooperation has in the “but for” sense combined with the conduct of a primary violator in bringing about a violation. This term encompasses

complicity policies go beyond merely proscribing knowing assistance of one sort or another and refer to a whole range of legal rules and standards designed not only to cause secondary persons to withhold assistance for, but also to ferret out and prevent conduct and practices that would violate fundamental securities law prohibitions.

This article contends that a rules-based approach with respect to secondary parties would be generally preferable to exclusive reliance on a standards-based regime. Rules provide direct prospective guidance to potential secondary actors. For example, requiring certain conduct, such as certification from a secondary actor, removes any ambiguity as to the responsibility of that person. Second, rules mitigate the potential of secondary actors to rationalize acts of assistance to a primary actor. By putting the secondary actor on notice of societal expectations, the rules ensure that a secondary actor cannot ignore the potential enforcement concerns inherent in particular situations.

The rules-based approach to secondary liability differs from a standards-based approach in two important respects. The rules-based approach promotes prospective clarity regarding the secondary party's obligations. In addition, it substantially modifies the conventional approach where primary liability is a predicate for secondary liability (i.e., there can be no secondary liability absent primary liability). A rules-based regime need not be tethered to a finding of primary liability in this fashion. As a result, the secondary actor's duties are defined with greater precision at the outset and the secondary actor is less likely to discount his potential liability by contingencies concerning whether the primary actor is in fact engaged in unlawful conduct or the probability that the secondary party's role is likely to evade detection even if the primary actor's unlawful conduct is subsequently detected.

There is another area of potential difference between rules-based and standards-based anti-complicity regimes. The standards-based regime has triggered an enormous policy debate regarding whether injured investors should enjoy a remedy for damages against established aiders and abettors comparable to any damages remedy afforded against primary actors (i.e., in fraud actions).¹² After *Central Bank*, of course, federal policy has

many classes of potential participants, such as fellow employees and transaction counterparties, and a wide range of cooperative activities. Anti-complicity policies in this sense go beyond regulating acts of deliberate and active cooperation, and are not limited to conventional gatekeepers, but rather extend to all persons whose conduct or responsibilities are proximately connected to misconduct of a primary violator.

12. That is not to say that all standards-based sanctions entail liability for damages. Clearly, liability for damages is not available where the primary violation itself does not afford a remedy in damages, or where sanctions are based on violations that do not rise to the level of aiding and abetting such as a "causing violation."

foreclosed liability for damages against complicit secondary actors,¹³ but this is a contested area that is subject to legislative revision. Rules-based anti-complicity strategies, in contrast, tend to cut against recognition of private damage remedies.¹⁴ Because of the prospective preventative rationale underlying a rules-based anti-complicity regime, there would be a strong presumption against any corresponding damages remedy since rule violations will not necessarily result in injured investors. Moreover, the existence of effective rules-based anti-complicity strategies would actually weigh against policy arguments for providing a damages remedy for standards-based aiding and abetting by diminishing the need for additional forms of deterrence. The existence of an effective alternative rules-based scheme would militate against expanding liability under a standards-based regime.

The challenge presented by this topic lies in deriving meaningful generalizations from a myriad of anecdotal situations involving secondary actors. How can we ever know whether rules-based strategies might be more effective in general than standards-based strategies? This article constructs an argument for greater reliance on a rules-based regime based on an analysis of key structural features in understanding anti-complicity strategies in the securities law context. In Section I, the article begins with several illustrations of securities law violations that raise recurring issues of complicity so that readers have a concrete idea of the underlying context. Section II examines the economic and behavioral logic underlying anti-complicity policies and recurrent contextual features of complicity problems arising in the securities law context to gauge the feasibility of a rules-based regime and to assess the relative strengths and weaknesses of rules- and standards-based regimes. Section III discusses the structure and analyzes the relative success of aiding and abetting standards (and quasi-aiding and abetting standards) as a strategy for deterring complicity, while Section IV argues, in light of this analysis, that reliance on aiding and abetting standards as the principal regulatory anti-complicity strategy in the securities law area is unsound.

Section V of the article briefly surveys use of rules-based strategies that have been introduced on an ad hoc basis in specific securities contexts. The article's concluding section, Section VI, makes the general argument that a more comprehensive and systematic approach to rules-based anti-complicity strategies is both desirable and feasible, and then offers a proposal that would enable the SEC, by regulatory initiative, to expand reliance on rules-based anti-complicity strategies. As explained below, a

13. *See infra* Section III.C (examining current federal policy and consequences flowing for secondary actors).

14. *See infra* Section IV (analyzing the standards-based anti-complicity strategy and its shortcomings).

regime of explicit contextualized bright-line rules that varies across types of transactions and types of secondary actors (e.g., gatekeepers, transactional counterparties, and employees) is likely to be effective in eliciting the type of behavior from secondary parties that would be most useful in impeding primary violations. These standards should be formulated by the SEC, given the SEC's relative institutional competency and rulemaking capacity, rather than by courts.

I. SOME EXAMPLES TO THINK ABOUT

Comparing the relative merits of rules-based and standards-based regimes obviously involves a fair degree of abstraction. Therefore, it is perhaps useful to begin with some simple, recent, concrete examples of conduct—raising questions of complicity that show how problematic liability determinations can be in the securities law context. The examples will be useful later on to show how a rules-based regime might be more effective than a standards-based regime in changing the behavior of secondary actors.

A. *Affirmatively Accommodating Confederates*

Let's begin with an SEC matter involving Delphi Corporation, nine executives, and four third parties.¹⁵ The enforcement matter arose out of several commercial transactions structured to enable Delphi to report false financial results based on improper accounting treatment of the transactions at the end of Delphi's 2000 fiscal year. Delphi consented to judgment with respect to the alleged securities law violations involving fraud, improper reporting, and improper accounting books and records.¹⁶ Three instances of fraudulent accounting practices by Delphi required knowing assistance from employees of three outside firms, but the three different transactions triggered significantly different outcomes for the complicit parties.

In one transaction, Delphi received a sham lump sum \$20 million payment from a friendly "IT service provider" and then treated the payment as a reduction in current expenses (in the form of a non-refundable

15. The matter resulted in an enforcement action and several related administrative proceedings. Delphi Corp., Litigation Release No. 19,891, 2006 WL 3068567 (Oct. 30, 2006) [hereinafter Delphi Litigation Release]; Complaint at 2–12, Delphi Corp., Civil Action No. 2:06-cv-14891 (E.D. Mich. Oct. 30, 2006) [hereinafter Delphi Complaint].

16. Subsequently, two audit partners with Deloitte & Touche LLP were sanctioned in connection with the audit opinions rendered by the outside auditor, barring the two from practicing before the Commission. *In re Higgins*, Exchange Act Release No. 57,380, 2008 WL 508173 (Feb. 26, 2008), *In re DiFazio*, Exchange Act Release No. 57,381, 2008 WL 508174 (Feb. 26, 2008).

rebate).¹⁷ In a side arrangement, Delphi agreed to repay the lump sum over a five-year period with interest, and the repayments were disguised through the IT company's inflated service invoices (on a roughly \$200 million contract) and a factoring arrangement with another third party finance company that accelerated certain payments to the IT company.¹⁸ As a result, Delphi improperly reduced its current expenses (in the form of a non-refundable rebate), thereby inflating its reported net income in 2000. It deferred recognition of the offsetting liability into subsequent accounting periods.

Delphi's fraudulent accounting required the complicity of the IT company and its employees. The IT company employees provided an intentionally vague side letter and inaccurate work orders to Delphi to conceal the economic substance of the arrangement.¹⁹ As to the complicit parties' liability, two client executives for the IT company, who completed false documentation, settled cease-and-desist (C&D) proceedings for causing Delphi's violations of reporting and books and records provisions.²⁰ A senior accounting officer of the IT company—indeed the officer responsible for the IT company's own generally accepted accounting principles ("GAAP") compliance—who allegedly had reviewed and discussed the arrangement and contracts providing the \$20 million payment, was charged with aiding and abetting Delphi's misconduct in the injunctive action.²¹ He contested the charges and they were eventually voluntarily dismissed.²² The IT company was never charged.²³

In another transaction, Delphi employees arranged to sell \$70 million in generator cores and battery inventory to a privately-owned consulting company (with an ongoing consulting relationship with Delphi) and agreed to repurchase the inventory the next quarter, in return for which the consulting company received a fee for its assistance.²⁴ The transaction involved a number of suspicious circumstances. The inventory always remained in Delphi's possession.²⁵ Delphi arranged for the consulting company's financing of the transaction and its payment was not received

17. Delphi Complaint, *supra* note 15, ¶¶ 71–87.

18. *Id.* at ¶¶ 72–73.

19. *Id.* at ¶¶ 77, 79–80, 84, 86.

20. *In re* Curry, Exchange Act Release No. 54,668, 2006 WL 3068566 (Oct. 30, 2006); *In re* Doyle, Exchange Act Release No. 54,666, 2006 WL 3068564 (Oct. 30, 2006).

21. Delphi Complaint, *supra* note 15, at ¶¶ 80–81, 87.

22. Delphi Corp., No. 2:06-cv-14891-AC-SDP, 2009 WL 3395583 (E.D. Mich. Aug. 3, 2009).

23. *See generally* Delphi Complaint, *supra* note 15 (listing the SEC's charges against Delphi Corporation).

24. *Id.* at ¶¶ 55–67.

25. *Id.* at ¶ 62.

before the end of the last quarter in 2000.²⁶ The consulting company had never engaged in such a transaction and had no business relevant to the transaction.²⁷ The chief executive officer of the consulting company overruled his outside counsel who had advised that any contract should reflect the purchase and repurchase agreement in a single written document.²⁸ Instead, the repurchase arrangement was left in the form of an oral agreement.²⁹

Delphi's disclosure and the financial results in its Form 10-K were materially misleading as they related to the transaction. There was no true sale of inventory: rather, Delphi had sold inventory to itself to remove inventory from its balance sheet and recognize income on its income statement. The chief executive officer and sole owner of the consulting company, the complicit party in the transaction, consented to a cease-and-desist order for "causing" the fraud, reporting, books and records violations, settling a civil action seeking civil penalties and disgorgement, and alleging that he had aided and abetted Delphi's violations.³⁰

In a third transaction, Delphi once again entered into a precious metals transaction with a bank.³¹ Delphi sold roughly \$200 million in precious metals from Delphi to a large commercial bank in an end-of-quarter transaction,³² and simultaneously entered into a forward agreement to repurchase the identical metals from the bank.³³ The price differential in the two contracts reflected the bank's fees and costs for executing a loan transaction.³⁴ The prices did not appear to correspond to the market value of the metals inventory.³⁵ Delphi recognized immediate income from the first leg of the transaction and deferred costs into a later accounting period.³⁶ Although the bank was arguably complicit in that the bank was aware that Delphi was engaged in an accounting transaction to remove the inventory from its books, the bank did not appear to provide any false documents to facilitate the transaction.³⁷ Although Delphi and its employees were sanctioned, the bank and its employees were not.³⁸

26. *Id.* at ¶ 60.

27. *Id.* at ¶ 57.

28. *Id.*

29. *Id.*

30. *In re Bahadur*, Exchange Act Release No. 54,665, 2006 WL 3068563 (Oct. 30, 2006). Bahadur separately consented to disgorge the payments his company had received from Delphi and pay a civil penalty.

31. Delphi Complaint, *supra* note 15, ¶¶ 46–54.

32. *Id.* at ¶¶ 46, 51.

33. *Id.* at ¶ 51.

34. *Id.* at ¶¶ 53–54.

35. *Id.*

36. *Id.* at ¶¶ 46, 54.

37. *Id.* at ¶¶ 46–54.

38. Delphi Litigation Release, *supra* note 15.

These proceedings raise several illustrative kinds of considerations regarding complicity. All three transactions clearly entailed the complicity of counterparties, but the dispositions widely varied: firms were generally not held liable and individuals were; and in some cases, neither individuals nor firms were regarded as legally complicit, though the circumstances strongly suggested both awareness and assistance (e.g., the bank). Although the evidentiary record as to actual knowledge by the outside parties is uneven (and probably accounts for the disparity in outcomes), in each case, the details of the transaction alone were sufficiently suspect to raise questions of complicity. As a policy matter, one would hope that complicit assistance could be discouraged in all three transactions. The question posed in the remainder of this article is whether rules-based or standards-based strategies are better suited to achieving anti-complicity outcomes in similar situations.

B. The Disengaged Employee

Nicolas Howard was a senior executive in the American broker-dealer subsidiary of a U.K. brokerage firm.³⁹ He was the lead executive for the broker-dealer in placing into the U.S. the shares of a foreign hotel company on whose board he sat.⁴⁰ The offering was a conditional best efforts offering which required the American broker-dealer to sell a minimum number of shares as set forth in the offering by a stated date, or return funds raised from U.S. investors who purchased shares in the offering.⁴¹ The offering did not conform to the regulatory requirements governing such offerings because it counted shares sold to affiliated parties toward the minimum and failed to actually collect nearly one-third of the funds raised in the offering by the stated date.⁴² Both the court and the parties appeared to agree that the American broker-dealer had violated the SEC regulations governing conditional offerings.⁴³ The SEC had also concluded that Howard had aided and abetted his firm's violation of U.S. regulations because of his central role in overseeing the offering, his active

39. *Howard v. SEC*, 376 F.3d 1136, 1138 (D.C. Cir. 2004).

40. *Id.* at 1138–39.

41. *Id.* at 1140.

42. *Id.* at 1140–41.

43. *Id.* at 1146 n.17. One issue glossed over in the text of the opinion is whether Rule 10b-9 is a scienter-based offense. If viewed as an antifraud rule, then it is scienter-based. *Cf.* Fred N. Gerard & Michael L. Hirschfeld, *The Scienter Requirement Under Rule 10b-6*, 46 BUS. LAW. 777 (1991) (arguing that all Section 10(b) rules implicitly require scienter). The firm can only be liable if someone in the firm had the requisite mental state. At the same time, a reading of the rule and its administration suggest a prescriptive regulation. The opinion does not resolve the tension between holding a firm complicit for liability under Rule 10b-9, but seemingly forecloses that result as to individuals.

involvement in marketing the shares, and his efforts to collect overdue payments from clients after the stated date.⁴⁴ The court of appeals overturned the finding as to Howard because there was no showing that he actually was aware of any “illegalities,” and his conduct, contrary to the SEC’s finding, should not have been regarded as reckless.⁴⁵ Although the facts showed that the first offering had not been completed in compliance with the SEC regulations or the placement documents, the court noted that the record showed that Howard had not involved himself in the drafting of the documents and had only skimmed them, choosing to rely on the firm’s outside counsel and firm employees to ensure compliance.⁴⁶ He seemed to have received oral assurances to that effect from an employee and did not raise questions about the transactions that did not qualify toward the minimum because he was unfamiliar with the SEC regulations.⁴⁷

What is undeniable in this matter is that Howard was the senior executive in charge and actively assisted in completing the offering. He never took it upon himself, however, to consult directly with outside counsel or ensure compliance with the relevant requirements. His firm could be held liable but, according to the court, Howard could not be held liable for complicity, even if he was the employee most responsible for his firm’s actions, because he failed to meet the requisite culpability standard. If society’s interest lies in preventing violative conduct by firms in similar circumstances, then surely insulating responsible employees for complicity in assisting their own firm’s misconduct, based on a high culpability threshold for personal culpability, undermines anti-complicity policies. The question posed in this illustration, as above, concerns whether rules-based or standards-based strategies are better suited for achieving anti-complicity outcomes in similar situations.

C. *The Willingly Acquiescent Confederate*

In a recent injunctive action, the SEC unsuccessfully sought injunctive relief against the complicit chief financial officer, Joseph Apuzzo, of a counterparty to a public company that engaged in fraudulent financial reporting.⁴⁸ Apuzzo, acting for his company, allegedly agreed to a request from the chief financial officer of United Rentals, a public company, to re-characterize various aspects of the two companies’ transactions and to use side agreements to keep material elements out of the principal underlying

44. *Howard*, 376 F.3d at 1137.

45. *Id.* at 1142–47.

46. *Id.* at 1139.

47. *Id.* at 1140–41.

48. *SEC v. Apuzzo*, 758 F. Supp. 2d 136, 138–44 (D. Conn. 2010), *appeal docketed*, No. 11-696 (2d Cir. 2011).

intercompany agreements.⁴⁹ Apuzzo specifically offered to provide a letter in the case of one transaction that verified an inflated appraisal, knowing that it would be inaccurate.⁵⁰ Apuzzo was willing to do so to complete the transaction and because United Rentals had agreed to indemnify his company for losses resulting from the misvaluation.⁵¹ The misleading appraisal letter, however, was never ultimately prepared and delivered to the independent auditor. The SEC alleged that Apuzzo's actions collectively, including executing the relevant agreements, amounted to substantial assistance in United Rentals' fraudulent financial reporting.⁵²

Although finding that the SEC had sufficiently alleged Apuzzo's actual knowledge of the public company's fraudulent reporting,⁵³ the district court nevertheless dismissed the aiding and abetting action against Apuzzo on the grounds that Apuzzo's conduct had no more than a "but for" causal relationship to the fraud and therefore did not constitute the requisite substantial assistance.⁵⁴ According to the district court, willingness to deliver a misleading appraisal letter or to execute documents designed to conceal the true nature of the transactions "[did] not support a conclusion that Apuzzo's conduct proximately caused the primary violation."⁵⁵

This case bears some similarity to the first example where some counterparties were sanctioned and others were not, but differs in one key respect. Apuzzo's conduct in going along with the primary violator's scheme (by offering to sign a false appraisal letter and agreeing to execute documents that disguised the true nature of the transaction) was deemed legally insufficient to show complicity.⁵⁶ One possibility is that the case will be reversed on appeal. Even if it is not, however, it is apparent that the standards-based approach does not reach a result consistent with sound policy. The goal of anti-complicity policies should be to deter acts of acquiescence that serve to advance another's violations of law, even if only to disrupt the primary violator's confidence in proceeding in an

49. *Id.* at 138–44.

50. *Id.* at 142.

51. *Id.*

52. *Id.* at 140.

53. *Id.* at 146–50.

54. *Id.* at 149–53.

55. *Id.* at 152.

56. Apuzzo, as a non-employee is not subject to the direct legal obligations applicable to United Rentals' own corporate officers where express prohibitions affect the latter individuals' accountability for the company's financial reporting under rules such as Exchange Act Rule 13b2-2, 17 C.F.R. § 240.13b2-2 (2011), a rule directly aimed at officers and directors of the reporting company, but not third parties. Not surprisingly, the SEC obtained sanctions against United Rentals' senior officers involved in the transactions. Milne, Litigation Release No. 20,518, 2008 WL 926256 (Apr. 7, 2008); Nolan, Litigation Release No. 20,396, 2007 WL 4335549 (Dec. 12, 2007).

unlawful manner. Had Apuzzo declined to sign agreements that were designed to mislead the auditors, it seems plausible that the primary violator would have abandoned its efforts to use the transactions to manipulate its reported financial results. Once again, it is reasonable to ask whether policy is best served by standards that require the relevant tribunal to determine after the fact what constitutes substantial assistance or rules designed to curb obvious forms of socially disfavored cooperative conduct at the outset.

D. Institutional Complicity in Facially Lawful Transactions

As noted in the first example, an outside institution whose employees facilitate a primary violator's scheme, as in Delphi's case, may escape liability. The IT company was never charged, even though its employees were, and neither the outside bank nor its employees were charged, even though it was reasonably apparent to the bank that the transaction, which lacked any economic substance, was being used to alter Delphi's reported financial results. In certain circumstances, however, the SEC has proceeded against institutions as aiders and abettors.⁵⁷ A good example is the agency's action against J.P. Morgan in the Enron investigation.⁵⁸ In that matter, the SEC sanctioned J.P. Morgan, but ironically no individual employees of J.P. Morgan, for sponsoring sham structured transactions.⁵⁹ The transactions on their face did not entail any illegality, but inside J.P.

57. See, e.g., Veritas Software Corp., Litigation Release No. 20,008, 2007 WL 528458 (Feb. 21, 2007) (settling an aiding and abetting charge where software company agreed to purchase online advertising from large public internet company and others, and in return the sellers agreed to buy software at compensating inflated prices from the software company); *In re Int'l Bus. Machs. Corp.*, Exchange Act Release No. 55,954, 2007 WL 1827181 (June 25, 2007) (finding in settled administrative proceeding that IBM was a cause of fraudulent accounting and reporting violations at public company by buying old cash registers at an inflated price and selling new electronic cash registers at a corresponding inflated price).

58. J.P. Morgan Chase & Co., Litigation Release No. 18,252, 2003 WL 21738802 (July 28, 2003); Complaint, SEC v. J.P. Morgan Chase & Co., (No. H-03-28-77), 2003 WL 25575256 (S.D. Tex. July 25, 2003) [hereinafter J.P. Morgan Complaint]. A private securities law action for primary liability brought by J.P. Morgan's shareholders against J.P. Morgan arising out of the same facts was dismissed because plaintiffs failed to meet the PSLRA's pleading standard for scienter. *ECA v. J.P. Morgan Chase & Co.*, 553 F.3d 187 (2d Cir. 2009).

59. J.P. Morgan Chase & Co., Litigation Release, *supra* note 58. In the derivatives transactions, Enron entered into prepaid forward transactions with a shell company controlled by J.P. Morgan, which in turn entered into a mirror transaction of the first leg with J.P. Morgan and then J.P. Morgan would enter into its own mirror transaction of the second leg with Enron. When the parties' economic positions in the transaction were netted, Enron had received a fixed payment and J.P. Morgan, after netting out the repayment of the loan, was left with an amount that corresponded to the imputed interest on the loan. J.P. Morgan Complaint, *supra* note 58, ¶¶ 12–29.

Morgan, employees recognized that the transactions had no economic substance and appeared to be used by Enron to disguise its receipt of loans in financing its business operations.⁶⁰ As Enron illustrates, transactions that may be facially lawful can be used to advance fraudulent accounting schemes. Society has an interest in discouraging complicity by institutional third parties (e.g., investment banks) in these nominally lawful transactions, but there is little guidance regarding when institutions, institution employees, or both, will be liable under a standards-based scheme.⁶¹ Again, it is worth asking whether anti-complicity objectives in such situations are best served by a standards-based regime or a rules-based regime.

II. RETHINKING THE CONCEPTUAL FRAMEWORK FOR REGULATING COMPLICITY UNDER FEDERAL SECURITIES LAW

Much of the academic debate regarding complicity under the securities laws has taken place within very narrow bounds. Typically, the debate focuses on specific problems arising in the case law relating to aiding and abetting and its elements. The resulting analysis then uses either policy considerations to expand or contract the zone of liability, or case law to show pernicious policy effects arising from the particular standard applied. This form of debate obscures structural issues relating to the economic and behavioral realities underlying legal policies aimed at deterring complicity, and largely preempts any consideration of alternative anti-complicity strategies in relation to aiding and abetting standards.

This section instead refocuses the discussion relating to anti-complicity initiatives on first principles in terms of methods and objectives. There is a substantial legal literature concerning the economic logic of gatekeeping,⁶² which can be generalized to provide useful insights into the

60. J.P. Morgan Complaint, *supra* note 58, ¶¶ 33–37.

61. This uncertainty did not exist in pre-*Central Bank* private litigation. Private litigants sought the deepest pockets and routinely sought to hold the institutional employer liable, rather than the employee, on a respondeat superior theory. The SEC has not followed a consistent approach. In *Delphi*, as discussed above with respect to the IT Company and the bank, and in other cases, the SEC has declined to proceed against institutions. See e.g., *In re NutraCea*, Litigation Release No. 21,819, 2011 WL 194505 (Jan. 20, 2011) (electing not to proceed against company that putatively “purchased” millions in product from public company in a fraudulent accounting scheme); *In re Orr*, Litigation Release No. 18,989, 2004 WL 2785506 (Dec. 2, 2004) (sanctioning corporate officers from vendors such as Kodak, Coca-Cola, Pepsi-Cola, and Frito-Lay for aiding and abetting fraud and reporting violations by K-Mart, but declining to bring actions against corporate vendors).

62. See, e.g., Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583 (2010) (analyzing gatekeeper liability, particularly in business transactions, as a phenomenon to which multiple gatekeepers contribute, rather than one in which individuals independently operate); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003) (discussing the

economic logic of complicity. The gatekeeping literature has resulted in many policy prescriptions in the securities law area, especially in the area of private liability standards.⁶³ This section attempts to motivate the economic and behavioral understanding of anti-complicity policy in the securities law context, and the relationship of those standards to a broader range of anti-complicity policies. Unlike other analyses, this section also develops a contextual taxonomy for complicity that identifies recurrent patterns of conduct by secondary actors that contribute to securities law violations. The combination of factors—identifiable recurrent patterns of complicit conduct, behavioral factors that lead to complicit conduct, and the economic logic of anti-complicity strategies—are used to support the article’s central contention that rules-based anti-complicity strategies in the securities context are an effective alternative to exclusive reliance on standards-based strategies.

A. *The Economic and Behavioral Logic of Regulating Complicity*

Simplified economic models of human and firm behavior provide a framework for understanding the rationale for anti-complicity policies. The focus of these models is to evaluate whether market (or private) incentives alone are likely to lead optimizing agents to adopt socially optimal behaviors when interacting with other persons who may be engaged in unlawful conduct. Anti-complicity policies are desirable if they induce conduct that leads to more socially efficient outcomes than would occur in their absence. Thus, in order to prevent fraudulent

policy implications of enhancing gatekeeper liability); Kraakman, *supra* note 11 (examining the economic ramifications of imposing gatekeeper liability). Though somewhat less theoretical, Professor Coffee provides a comprehensive examination of the connection between theory and application in this area. JOHN C. COFFEE, JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* (2006) [hereinafter COFFEE, *GATEKEEPERS*].

63. See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) (suggesting that the 2001–2002 uptick in financial reporting and accounting irregularities resulted from professionals failing to perform their gatekeeping duties); John C. Coffee, Jr., *Partnoy’s Complaint: A Response*, 84 B.U. L. REV. 377 (2004) (challenging the strict liability approach to gatekeeper liability theory which Partnoy suggests); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365 (2004) (defending Partnoy’s strict liability theory in response to Coffee’s paper by discussing contact rights versus regulation, and potential damages in gatekeeper liability); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491, 492 (2001) (proposing a “modified strict liability regime that would avoid many of the problems and costs associated with the current due diligence-based approaches”). For an interesting alternative to liability, based on rewards, see Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323 (2007) (offering the theory that a rewards-based initiative may overcome shortcomings of a deterrence-based gatekeeper liability system).

misrepresentations that affect securities transactions, society can choose whether to simply prohibit material misrepresentations and impose liability on only those persons making such misstatements, or to implement a mix of regulatory requirements that are directed not only at the person making the misstatement, but other persons whose conduct contributes to the primary actor's willingness and ability to make misstatements. Framing the issue of anti-complicity in the latter way necessarily imports underlying assumptions. Most importantly, it assumes the validity of regulating the conduct of the primary actor. For example, in the context of securities regulation, there is a need for antifraud prohibitions and mandatory disclosure by public companies.⁶⁴ This simplifies the question of anti-complicity regulation to one of whether anti-complicity policies in combination with regulation of primary actors may lead to more efficient regulation than relying solely on regulation of primary actors.⁶⁵

The purpose of sanctioning secondary participants is to create indirect obstacles for primary violators in accomplishing unlawful activities.⁶⁶ Many types of securities law violations occur within factual contexts where there is a significant degree of interaction and coordination in terms of infrastructure and participants, and thus many opportunities to create additional safeguards. While anti-complicity policies may not result in revelation of unlawful schemes generally, they may nevertheless lead to greater compliance by causing secondary actors to deny primary violators necessary assistance for their unlawful conduct.

In a similar vein, even where a primary violator is ultimately able to secure the requisite complicit assistance, anti-complicity policies will nevertheless have a specific cost-deterrent effect at the margin. Anti-complicity policies increase the costs of coordinated activity for the primary violator. Secondary participants are less willing to participate or "look the other way" when a regime sanctions complicit behavior. Thus, the cost of mustering resources for primary participants will increase in terms of search, compensation, and concealment. Finally, anti-complicity policies may increase the likelihood of primary violation detection after the fact, as compliance systems of secondary participants identify anomalies in prior transactions. Increased likelihood of detection will enhance the deterrent effect of primary sanctions.

64. See generally Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223 (discussing the justifications for antifraud prohibitions and mandatory securities disclosure).

65. Professor Hamdani approaches this inquiry from a different direction. He assumes primary actors are judgment-proof, and then proceeds to ask what damage liability regime would be most appropriately applied to gatekeepers. Hamdani, *supra* note 62, at 65.

66. *Id.* (arguing that policies favoring gatekeeper liability are strongest when the gatekeeper is in a position to monitor the primary actor and is able to prevent wrongdoing).

In addition, primary and secondary actors face different incentives in connection with unlawful behavior. Primary actors may be relatively insensitive to civil sanctions if the rewards from unlawful conduct are great, particularly if the risk of detection is low or monetary sanctions are inadequate. This may be especially true where the unlawful conduct is relatively small in magnitude and hard to distinguish from lawful conduct. In contrast, secondary participants may profit very little from the primary violator's unlawful conduct and may be more sensitive to sanctions at the margin. Although society may be able achieve the same level of overall compliance with primary liability standards, presumably such a result would require far more significant sanctions for primary violators. Indeed, primary-only sanctions might need to be unusually punitive to bring about the desired level of deterrence. If so, such sanctions could have potentially adverse social consequences either by causing law-abiding participants to bear excessive precautionary costs or by causing them not to engage in economically desirable activities.

By making secondary actors accountable, anti-complicity policies may permit the imposition of a less draconian regulatory regime directed exclusively at primary actors. More moderate forms of threatened sanctions on both primary and secondary actors may prove sufficient to bring about the same level of compliance, but could have less distortive effects on legitimate business activities than exclusive reliance on sanctions directed exclusively at primary actors. Of course, imposing liability on secondary actors will, in addition to making them marginally more cautious in their dealings, impose added costs on the services rendered by such actors (reflecting the added precautionary costs and the greater potential for regulatory penalties and legal fees). The challenge of a two-tiered enforcement strategy is to achieve a more efficient enforcement policy mix: one that produces optimal levels of enforcement and compliance at lower costs.

Complicity also has a strong behavioral component⁶⁷ and thus behavioral considerations are potentially instructive about anti-complicity strategies.⁶⁸ Complicit participants will exhibit a spectrum of motivations,

67. Cf. Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1818 (2007) (examining the Sarbanes-Oxley Act's social "diffusion" to gauge its effect on corporate practices).

Socio-legal researchers tell us . . . that even the coupling between official legal interpretations and social behavior is fairly loose—that absent unusually high rates of detection and prosecution, compliance decisions are based at least as much on the perceived legitimacy of the law and prevailing norms in local context as any deliberate risk calculation.

Id. (footnote omitted).

68. See, e.g., Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411,

ranging from the virtually conspiratorial to the passively acquiescent. The vast behavioral literature emphasizes that it is unreasonable to assume that individuals are rational optimizers, but rather that they are easily self-deceived and disposed to cognitive errors.⁶⁹ Given these predispositions and the central role of coordination and collaboration in any complicit arrangement, it is plausible to believe that certain (and possibly multifaceted) strategies may be more effective than others in disrupting and combating particular patterns of complicit behavior.

Complicity commonly involves situations where the primary violator corrupts, manipulates, or induces the secondary actor to behave complicitly. Economic pressure provides the most obvious means for influencing the behavior of secondary actors. Frequently, fees or compensation are implicitly conditioned on rendering assistance to the primary violator, or at least on being acquiescent to the primary actor's conduct, even in the face of concerns.

Even absent economic coercion, the social dimension of the relationship between primary and secondary actors may be sufficient to cause the secondary actor to behave imprudently in his or her dealings with the primary actor.⁷⁰ This risk is obviously greatest where primary and secondary actors have had continuous dealings over an extended period of time. Professor Donald Langevoort has persuasively argued that behavioral factors, such as motivated inference (the psychological discomfort that pushes actors to make benign inferences), status quo bias (the tendency to interpret data in terms of pre-existing frames of reference such as when conduct seemed entirely legitimate), attribution bias (the tendency for observers and actors to experience the same situational facts from different perspectives), and rationalization (the tendency to resolve the cognitive dissonance created when firmly held norms of behavior conflict with actual behavior) are critical to understanding compliance patterns and practices within business organizations.⁷¹ These same behavioral attitudes shape the interactions between primary and secondary

418–21, 436–46 (2008) (applying behavioral realist assessment of psychological factors affecting gatekeeping roles of inside and outside counsel).

69. For a useful introduction to the legal literature on behavioral economics, see generally Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998) (analyzing the intersection of behavioral economics and legal economic analysis); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051 (2000) (analyzing how law and economic policy may stand to benefit from policymakers implementing a more behavioral science approach).

70. Cf. Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71 (2002) (examining how knowledge of behavioral predispositions should inform the design of internal corporate compliance systems).

71. *Id.* at 84–95.

participants more generally. What is common to these instances of behavioral corruption or assimilation is that behavioral attitudes make non-deliberate forms of complicity more likely over time as a secondary actor becomes more conditioned in his or her relationship with the primary violator.⁷² Given this behavioral context, it is necessary to consider whether a rules-based or standards-based regime might be more successful in counteracting these tendencies.⁷³

B. Recurring Contextual Schema for Complicity in Securities Law Violations

Securities law violations frequently involve cooperative behavior among several participants. The cooperative behavior, especially in cases of systematic fraud or abuse, may involve the willing participation, acquiescence, or indifference of at least several persons, and more likely many people in one or more organizations. In many securities contexts, primary violations must pass under the eyes of many before causing injury to the investing public. For example, the massive financial reporting fraud involving Enron involved law enforcement actions against many individuals, and journalistic accounts indicate that many within Enron suspected or were alerted to improprieties.⁷⁴ Many employees of mutual funds must have been aware of the late trading and market timing problems encountered by firms.⁷⁵ The Madoff debacle provides ample evidence that multi-billion dollar ponzi schemes simply do not happen without a lot of assistance or, at least, raised eyebrows.⁷⁶ Organizations are by their very

72. This tendency is likely exaggerated in reality by the fact that, over time, the primary violator's selection bias will skew toward secondary actors that are the most pliable.

73. See generally Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23 (2000) (analyzing the costs and benefits of rules-based and standards-based regimes using both behavioral and economic analysis).

74. The SEC ultimately concluded proceedings against roughly two dozen Enron employees and another dozen third-parties. The orders are collected on the SEC's website at <http://www.sec.gov/spotlight/enron.htm>. Among the numerous journalistic accounts relating to Enron, all substantiate the existence of a culture of complicity. See, e.g., KURT EICHENWALD, *CONSPIRACY OF FOOLS* (2005) (supporting the theory that such a culture of complicity existed at Enron).

75. In a widely repeated pattern, many mutual funds allowed preferred investors to advantageously make trades after closing based on former, rather than future, closing prices (late trading) or to systematically exploit anomalies in the pricing of portfolio securities by accepting large trades near the end of the close (market timing). This kind of trading activity was plainly evident to many employees of the fund adviser, such as portfolio managers. See, e.g., *In re Invesco Funds Group, Inc.*, Exchange Act Release No. 50,506, Investment Company Act Release No. 26,629, 2004 WL 2270297 (Oct. 8, 2004) (describing internal awareness at one fund group regarding such improper trading transactions).

76. A ponzi scheme of the magnitude underlying the Madoff fraud required enormous coordination among subordinates to operate. See *In re DiPascali, Jr.*, Exchange Act Release

nature beehives of cooperative activity, both within and outside the firm, and require significant amounts of teamwork, procedures, and feedback mechanisms in order to function in an orderly fashion.

As discussed below, many forms of complicit conduct in securities law violations seem to adhere to recurring patterns of observed conduct or interaction within organizations and among organizations. This fact is arguably significant in formulating policy. The existence of recurring patterns of complicit conduct may well support an argument for particular kinds of anti-complicity strategies, whereas highly unique forms of complicit behavior may require entirely different anti-complicity strategies. At least three broad patterns of complicit behavior are identifiable in the securities context: gatekeeper complicity, transactional counterparty complicity, and employee complicity.

Gatekeepers are perhaps the most well-known category of persons whose assistance may entail culpable complicity. The extensive literature on gatekeeping liability primarily focuses on reputational intermediaries; that is, firms that provide gatekeeping services on a professional basis, such as an independent auditor, underwriter, or outside counsel.⁷⁷ Although such firms may act in the narrow interests of clients, the services they render are of a professional nature, and the firms rendering the services provide them to multiple clients (and hence, they have a high concern regarding professional reputation).⁷⁸ While self-interest may act to check conduct assisting a primary actor, it is clearly not foolproof, and is arguably insufficient given flagrant examples of misconduct by reputational gatekeepers.⁷⁹

No. 60787, 2009 WL 3172846 (Oct. 5, 2009) (ordering sanctions against Frank DiPascali, Jr., a broker-dealer, investment adviser employee at Bernard L. Madoff Securities LLC); Complaint, SEC v. DiPascali, No. Civ. 09-CV 7085 (S.D.N.Y. Aug. 11, 2009) (describing the role of a Madoff operations lieutenant in orchestrating the production of false confirmations involving millions of pages of documentation and computer programming). The special bankruptcy trustee in the Madoff case has brought numerous lawsuits that contain allegations of knowledge that went beyond Madoff and his lieutenants, including an allegation directed at J.P. Morgan. See Michael Rothfeld, *Trustee: J.P. Morgan Abetted Madoff*, WALL ST. J., Feb. 4, 2011, at A1 (“While numerous financial institutions enabled Madoff’s fraud, JPMC was at the very center of that fraud, and thoroughly complicit in it,” according to the 115-page lawsuit, filed under seal . . . by the trustee recovering money for Mr. Madoff’s victims . . .”).

77. COFFEE, GATEKEEPERS, *supra* note 62, at 2–5; Kraakman, *supra* note 11, at 62, 70.

78. COFFEE, GATEKEEPERS, *supra* note 62, at 5; Tuch, *supra* note 62, at 1595.

79. In egregious instances, auditors have been charged with fraudulent conduct in connection with clients’ misconduct. See David Duncan, Litigation Release No. 20,441, 2008 WL 220063 (Jan. 28, 2008) (announcing defendant independent auditing partner’s consent to securities fraud injunction for recklessly signing “unqualified audit reports [that] . . . were materially false and misleading” relating to Arthur Andersen’s audit of Enron); KPMG, LLP, Litigation Release No. 19,573, 2006 WL 407506 (Feb. 22, 2006) (settling claims against four current and former KPMG partners, three of whom consented to

Some professional gatekeepers have explicitly defined regulatory roles, such as auditors⁸⁰ or transfer agents.⁸¹ In order to complete securities transactions for illicit purposes, primary violators have engaged other professional gatekeepers who are not independent by nature and may seek to advance the interests of clients, while remaining subject to professional standards or customs,⁸² such as attorneys⁸³ or broker-dealers.⁸⁴ As noted

injunctions; a fifth partner has previously consented to an injunction); KPMG, LLP, Litigation Release No. 19,191, 2005 WL 913469 (Apr. 19, 2005) (describing how KPMG knowingly facilitated Xerox's use of artificial accounting adjustments designed to disguise performance from investors and allow the company's performance to artificially exceed Wall Street expectations); Arthur Andersen LLP, Litigation Release No. 17,039, 2001 WL 687562 (June 19, 2001) (detailing the auditor's knowing complicity in use of accounting manipulations of Waste Management's actual results to attain predetermined earnings targets). Securities firms and securities analysts have also faced allegations of impropriety. *See* Federal Court Approves Global Research Analyst Settlement, Litigation Release No. 18,438, 2003 WL 22467373 (Oct. 31, 2003) (announcing approval of a \$1.4 billion final settlement with ten securities firms and two individual securities analysts relating to misconduct under exchange rules—and in some cases statutory requirements—in permitting investment banking interests to influence securities research).

80. Issuers and reporting companies must file audited financials, requiring the services of an independent auditor. 17 C.F.R. § 210.1-02(d) (2011) (defining audit to require an examination by an independent accountant for purposes of audited financial statements required in registrations statements under the Securities Act of 1933 and periodic reports under the Securities Exchange Act of 1934). Auditors have specific statutory reporting obligations. 15 U.S.C. § 78j-1 (2006). In addition, independent auditors must be registered with and are subject to rules and sanction by the Public Company Accounting Oversight Board. *See generally* 15 U.S.C. § 7201 (2006) (outlining basic definitions and requirements for independent auditors, and establishing the enforcement authority of the Public Company Accounting Oversight Board). As noted in the preceding footnote, auditors may be subject as primary violators, but are typically subject to lighter sanctions in connection with professional failings, such as a C&D order. *See, e.g.,* Ponce v. SEC, 345 F.3d 722 (9th Cir. 2003) (finding reckless certification of fraudulent financials and aiding and abetting the filing of false financial reports); KPMG, LLP v. SEC, 289 F.3d 109 (D.C. Cir. 2002) (negligently compromising independence in connection with contingency fee arrangement); *In re* Grant Thornton, LLP, Exchange Act Release No. 50,148, 2004 WL 1750732 (Aug. 5, 2004) (issuing C&D order for causing and aiding and abetting violations of the reporting provisions of the federal securities laws). For a discussion of standards-based sanctions relating to practice and appearance before the Commission, *see infra* notes 139–145 and accompanying text (discussing the SEC's enforcement authority over professionals engaging in misconduct).

81. *See* 15 U.S.C. § 78q-1(c), (d), (f) (2006) (describing the rules for registration of transfer agents, activities of transfer agents and their enforcement and the rules regarding the transfer of securities, respectively). A transfer agent's disregard of regulatory responsibilities can lead to liability for aiding and abetting securities law violations by others. *See In re* Holladay Stock Transfer Inc., Securities Act Release No. 7,519, Exchange Act Release No. 39,797, 1998 WL 130854 (Mar. 25, 1998) (sanctioning the transfer agent for removing restrictive stock legends, thereby aiding and abetting sale of unregistered securities in violations of Section 5 of the Securities Act).

82. Professor Laby labels this type of gatekeeper as a “dependent” gatekeeper to differentiate it from the “independent” gatekeeper model exemplified by auditors, securities analysts, and credit rating agencies. Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK.

above, enforcement proceedings and journalistic accounts involving egregious frauds provide a disturbing window to the involvement of gatekeepers whose conduct ranges from direct participation in primary violations to various lesser forms of complicity, such as aiding and abetting or causing violations or professional deficiencies, which can be evidence of awareness or suspicions of improprieties even though the gatekeeper does

J. CORP. FIN. & COM. L. 119, 127 (2006).

83. As with other gatekeepers, attorneys may engage in conduct that directly violates securities law. *See, e.g.,* Olesnyckyj, Litigation Release No. 20,056, 2007 WL 908009 (March 27, 2007) (settling a securities fraud injunctive action by former general counsel of Monster Worldwide for secretly backdating company stock options of other executives). In addition, providing legal advice and opinions may lead to sanctions for complicity. *See* Weiss v. SEC, 468 F.3d 849 (D.C. Cir. 2006) (affirming imposition of C&D against municipal bond counsel for negligently rendering unqualified opinion that interest on notes issued by school district would be exempt from federal income taxation); SEC v. Fehn, 97 F.3d 1276, 1289 (9th Cir. 1996) (affirming imposition of permanent injunction against an attorney for substantially assisting in primary violation of disclosure requirements by failing to advise client on material omissions in quarterly report); *In re Costanza*, Securities Act Release No. 7,621 (Jan. 6, 1999) (consenting to C&D order in connection with outside bond counsel's negligence in note offerings by Orange County where disclosure documents contained misleading omissions). In-house attorneys are especially susceptible to complicit conduct in connection with corporate transactions. *See* SEC Obtains Judgments Against One AIG and Four Gen Re Former Executives for Aiding in AIG Securities Fraud, Litigation Release No. 21,235, 2009 WL 3151070 (Oct. 1, 2009) (enjoining in-house attorney for aiding and abetting securities violations by drafting documents memorializing sham transactions between his company and AIG, a public insurance company, enabling AIG to make fraudulently misleading financial disclosures); SEC Charges Two Former Enron In-House Lawyers With Securities Fraud And Related Violations, Litigation Release No. 20,058, 2007 WL 923623 (Jan. 26, 2009) (settling fraud action against Enron in-house attorneys charged with omitting disclosure of Enron's related-party transactions with entities controlled by the company's chief financial officer); SEC Charges Two Former Enron Employees with Violating Federal Securities Laws, Litigation Release No. 19,623, 2006 WL 778713 (Mar. 27, 2006) (settling fraud action in which in-house attorney for Enron affiliate drafted transactional documents and concealed side agreements which resulted in Enron's filing material misleading annual financial statements); *In re Google, Inc.*, Securities Act Release No. 8523, 2005 WL 82435 (Jan. 13, 2005) (issuing C&D to general counsel based on his failure to tell board of risk that unregistered (and subsequently determined non-exempt) offerings were not exempt from registration or to alert board of disclosure obligations in connection with other unregistered offering of securities to employees). Unlike with auditors, the SEC typically refrains from bringing Rule 102(e) proceedings against attorneys unless the action is based on a settled or adjudicated proceeding or action. *See* Simon M. Lorne & W. Hardy Callcott, *Administrative Actions Against Lawyers Before the SEC*, 50 BUS. LAW. 1293 (1995) (discussing the origins of SEC policy regarding sanctioning attorneys under the predecessor to Rule 102(e), the so-called Rule 2(e)); *see also infra* notes 136, 196 (discussing further the SEC's enforcement authority over professionals, including attorneys).

84. *See* Graham v. SEC, 222 F.3d 994 (D.C. Cir. 2000) (sustaining administrative sanctions for associated person who aided and abetted a customer's fraudulent trading); Wonsover v. SEC, 205 F.3d 408 (D.C. Cir. 2000) (sustaining administrative sanctions for associated person who facilitated sale of unregistered securities in violation of the registration provisions of the Securities Act).

not share directly in any illicit profits.⁸⁵ One suspects (but cannot prove) that there exists a larger number of unreported “fellow traveler” incidents.⁸⁶

While reputational gatekeepers represent an important category of secondary participants, transactional counterparties represent another category. Transactional counterparties do not render gatekeeping services in the sense of professional gatekeepers, but rather engage in business transactions on a principal-to-principal basis directly with a primary actor’s firm. Transactional counterparties are in a position to disrupt the unlawful activity of primary violators by withholding assistance in the accomplishment of the primary violator’s scheme. The willingness of transactional counterparties, such as vendors of products or services, to document transactions in a misleading fashion or to provide false information to auditors is a recurrent situation.⁸⁷ In the case of Enron, investment bankers devised customized transactions—so-called “financially engineered” transactions—to meet financial reporting objectives that should have raised questions.⁸⁸ Indeed, underlying

85. See *supra* notes 79–84 for various examples of enforcement proceedings involving the issue of gatekeeper liability.

86. Numerous instances of potential complicity by gatekeepers likely are never made public because the primary violation is never discovered, the evidence connecting the third party to the underlying violation is undiscovered, or the third party’s conduct manifests itself in the form of neglect or indifference rather than any form of affirmative assistance. The metaphoric use of the pejorative term “fellow-traveler,” is not entirely faithful to its use in political context, but captures some sense of more subtle forms of complicity that are untouched by the current standards-based regime. See WILLIAM SAFIRE, *SAFIRE’S POLITICAL DICTIONARY* 240 (2008) (defining a fellow traveler as “one who agrees with a philosophy or group but does not publicly work for it”).

87. The facts underlying *Stoneridge* or in the Delphi matter illustrate this problem, but the circumstances are hardly unusual. *Stoneridge*, *supra* note 2; Delphi Litigation Release, *supra* note 15; see also *supra* notes 51–52 (providing further examples of cases regarding misrepresentation of transactional counterparties); Constance M. Boland & Lauren M. Sobel, *Holding Customers Liable for Their Suppliers’ Fraud: Should Customers Be Left Holding the Bag?*, 18 *INSIGHTS* 13, 17 n.4 (2004) (noting a then-emerging enforcement practice of naming “customers, vendors and suppliers” of public companies and asserting that the practice “constitutes a significant expansion of the SEC’s exercise of its enforcement authority”).

88. See Canadian Imperial Bank of Commerce, Litigation Release No. 18,517, 2003 WL 22996745 (Dec. 22, 2003) (charging Canadian Imperial Bank of Commerce and three of its executives with aiding and abetting Enron’s securities fraud); J.P. Morgan Chase & Co., Litigation Release No. 18,252, 2003 WL 21738802 (July 28, 2003) (alleging J.P. Morgan Chase as connected with accounting fraud in the Enron matter); *In re Citigroup, Inc.*, Exchange Act Release No. 48,230, 2003 WL 21738911 (July 28, 2003) (finding that Citigroup arranged prepay transactions—unrelated to those arranged by Chase—Involving two issuers, including Enron); Merrill Lynch & Co., Inc., Litigation Release No. 18,038, 2003 WL 1193551 (Mar. 17, 2003) (providing an example of one such institution in which bankers engineered such customized transactions); Complaint, SEC v. Merrill Lynch & Co., Inc., Civ. Action No. H-03-0946, (S.D. Tex. 2003) (alleging fraud in connection with its activities as a counterparty in putative asset sale and derivatives transactions). In another

allegations in the SEC's complaints revealed internal awareness by the counterparty of the questionable business purposes of the transactions.⁸⁹

Yet a third category of potential complicit participants is an artifact of statute, namely officers and employees of business entities that have obligations under the securities laws. Because some statutes and rules are specifically directed at the registered entities, such as reporting companies or broker-dealers, employees cannot directly violate the provisions; only entities can (albeit through the acts or omissions of officers and employees who themselves cannot be charged as primary violators).⁹⁰ Officers and employees, however, may be charged as aiders and abettors for active conduct that produces the violation,⁹¹ but only if their conduct can be shown to satisfy the relatively high standard of recklessness.⁹² In many circumstances, this standard can be difficult to meet. As a result, in a number of financial reporting cases, the entity may be liable even when no

case, the SEC found that an insurance company had engaged in securities fraud by devising non-traditional insurance policies that enabled an issuer to manipulate earnings reported in its financial statements. *See also In re Am. Int'l Grp., Inc.*, Exchange Act Release No. 48,477, 2003 WL 22110366 (Sept. 11, 2003).

89. Allegations contained in the SEC's complaint in settled actions illustrate the explicit awareness of investment bank employees regarding the questionable nature of some of the Enron transactions at the time the transactions were undertaken. For example, in *Merrill Lynch*, members of an internal bank committee openly questioned the legitimacy of transactions. Complaint, SEC v. *Merrill Lynch*, *supra* note 88, ¶ 25 (expressing concerns "whether Merrill Lynch could be viewed as aiding and abetting Enron's fraudulent manipulation of its income statement"). Similarly, e-mails and phone calls among J.P. Morgan employees evidenced recognition of the problematic nature of certain transactions. *See J.P. Morgan Complaint*, *supra* note 58, ¶ 27 (quoting written communication of a bank officer stating, "We are making disguised loans, usually buried in commodities or equities derivatives (and I'm sure in other areas). With a few [sic] exceptions, they are understood to be disguised loans and approved as such.").

90. *See, e.g.*, 17 C.F.R. § 240.13a-1 (2011) (outlining the annual reporting requirement: "Every issuer having securities registered pursuant to section 12 of the Act shall file an annual report . . ."); *see also* 17 C.F.R. § 240.13a-13 (2011) (requiring that such issuers, with some exceptions, must file semi-annual reports).

91. Where the reporting company is guilty of fraud, the SEC has obtained injunctive relief against responsible officers for the fraud violations. *See McConville v. SEC*, 465 F.3d 780 (7th Cir. 2006) (charging the CFO with violating Rule 10b-5 in connection with drafting and reviewing (but not signing) core financial statements that overstated profits); *Rand*, Litigation Release No. 21,114, 2009 WL 1884088 (July 1, 2009) (charging the CFO with fraud in orchestrating ongoing pattern of misstatements in company's public disclosure as part of an effort to manage earnings). In other cases, however, officers are charged with merely aiding and abetting or causing the company's non-fraudulent disclosure. (e.g., *In re Crittenden*, Exchange Act Release No. 62,593, 2010 WL 2992474 (July 29, 2010) (charging the CFO with causing misstatements in Citigroup's Form 8-K filing which reproduced misleading public communications previously made by the CFO)).

92. *SEC v. Steadman*, 967 F.2d 636, 647-48 (D.C. Cir. 1992); *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir. 1980), *cert. denied*, 449 U.S. 919 (1980).

employee is ever charged with a violation.⁹³ In other cases, an employee's purported ignorance of affirmative securities law requirements may constitute a defense against (or at least preclude) charges of complicity in the violation.⁹⁴

C. *Standards versus Rules*

The classification of legal norms into standards and rules provides a useful perspective for evaluating aiding and abetting liability relative to other forms of anti-complicity strategies.⁹⁵ Standards embody legal norms that require a high degree of judgment and discretion in relating a particular

93. This kind of situation is common where a reporting company is charged with a non-fraudulent reporting violation in a cease-and-desist proceeding and complicit individuals—even though corporate employees are actually responsible for the accounting and financial disclosure function—are not charged. *See, e.g., In re Gen. Elec. Co.*, Litigation Release No. 21,166, 2009 WL 2398241 (Aug. 4, 2009) (alleging financial reporting and fraudulent accounting misstatements arising from use of improper accounting methods based on judgments of “high-level GE accounting executives”); *In re Royal Dutch Petroleum Co.*, Exchange Act Release No. 50,233, 2004 WL 1883964 (Aug. 24, 2004) (charging the company for material misstatements relating to proved oil reserves); *In re Microsoft Corp.*, Exchange Act Release No. 46,017, 2002 WL 1159487 (June 3, 2002) (claiming materially inaccurate financial reporting arising from unsupported and undisclosed accounting reserves); *In re AOL Online, Inc.*, Exchange Act Release No. 42,781, 2000 WL 576215 (May 15, 2000) (discussing accounting misstatements arising from improper capitalized costs of acquiring new subscribers). There are some examples of the SEC bringing an action against complicit individuals for causing reporting violations where a reporting company is charged with a non-fraudulent reporting violation in a cease-and-desist proceeding. *See, e.g., In re Canepa*, Exchange Act Release No. 48,224, 2003 WL 23850249 (July 24, 2003) (sanctioning Arthur Andersen engagement partner in the Anika Therapeutics matter for causing reporting company's reporting violations in connection with improper revenue recognition on bill-and-hold transactions and improper accounting restatements after the original problem came to light); *In re Anika Therapeutics, Inc.*, Exchange Act Release No. 47,167, 2003 WL 103216 (Jan. 13, 2003) (sanctioning a reporting company, CEO, and CFO for causing company's reporting violations in connection with improper revenue recognition on bill-and-hold transactions and improper accounting restatements after the original problem came to light).

94. *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952 (7th Cir. 2004); *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004); *see infra* note 253.

95. The literature on standards versus rules is copious. *See, e.g.,* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (offering a functional perspective in understanding rules and standards); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985) (offering a nominalist perspective in suggesting distinction is illusory); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976) (analyzing normative implications of formulating legal directives as rule or standard); Korobkin, *supra* note 73 (comparing the rules- and standards-based approaches through a law and economics lens). *See also* Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988) (noting doctrinal ebb and flow between rules and standards in property law as the law has reflected pragmatic exigencies in its application).

legal directive to a particular factual context.⁹⁶ They tend to proscribe conduct in terms of purpose or effect, which does not alone lend itself to easy, bright-line determinations. The general prohibition on securities fraud found in Exchange Act Rule 10b-5 is a good example of a norm embodied as a standard. Securities fraud at a minimum requires deception relating to a material fact made with an intent to deceive in connection with a securities transaction.⁹⁷ The existence of a violation is determined not merely from objective facts but also from inferences relating to observable facts. Whether a person has been deceived, whether the person making a misrepresentation intended to deceive, or whether the misrepresentation involved a material fact, are all matters that require inferential judgments that will govern the application of the prohibition on fraud.

Rules, in contrast, are legal norms that are formulated in terms of bright-line requirements that are readily applied to known objective facts.⁹⁸ Traffic regulations, such as obeying speed limits or traffic signals, are obvious examples of legal rules.⁹⁹ Although rules and standards as types of legal norms lie on a continuum, the boundaries that separate these two categories are not relevant to this discussion. Needless to say, some legal requirements fall closer to the rule side of the continuum while others toward the standard side of the continuum.¹⁰⁰

While rules or standards offer different ways to bring about compliance with desired social policies, these categories clearly have attributes that may determine their effectiveness as legal norms in particular contexts. Rules are ideally suited for situations where the regulated conduct is easily described and the legal objective maps directly and unambiguously onto that conduct (e.g., society does not want drivers to go through red lights).¹⁰¹ Rules typically are more easily applied by an adjudicator after the fact than standards, but more importantly, they can be applied by the actor subject to the requirement *ex ante* with relative ease.¹⁰²

96. See Korobkin, *supra* note 73, at 27 (a standard “is a legal pronouncement that specifies no triggering facts that have defined legal consequences”).

97. THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION §12.4 478 (6th ed. 2006).

98. Korobkin, *supra* note 73, at 25 (“Rules establish legal boundaries based on the presence or absence of well-specified triggering facts.”).

99. *Id.* at 27.

100. See Kaplow, *supra* note 95, at 561–62 (analyzing speeding as both a rule and a standard); see also, Korobkin, *supra* note 73, at 29 (noting that a pure rule can become standard-like under certain circumstances, just as a pure standard can become rule-like through judicial reliance on precedent).

101. See Kaplow, *supra* note 95, at 586–90 (distinguishing between use of simple rules and complex standards).

102. Korobkin, *supra* note 73, at 25–26; see also Kaplow, *supra* note 95, at 560, 562–63 (distinguishing rules and standards in terms of “extent to which efforts to give content to the law are undertaken before [rule] or after individuals act [standard],” and noting rules

In this way, rules provide actors with greater clarity and guidance than standards regarding their legal obligations when confronted with a particular situation.

Although standards may provide fewer determinate outcomes *ex ante*, they may provide more relevant legal directives in difficult to anticipate circumstances. Complex conduct is more difficult to control or to cabin with a simple rule. Fraud can take many forms and thus a norm designed to prohibit such conduct must be expressed in terms of a standard. The rule of reason drawn from antitrust, which prohibits unreasonable restraints of trade, is another example where the legal norm is expressed as a standard rather than a rule. Standards are also particularly useful in addressing conduct that should be proscribed, but that can be deliberately tailored in ways to avoid application of a narrow rule.¹⁰³ In other words, standards generally are more successful in dealing with situations where circumvention of a rule is a genuine risk.

Liability for aiding and abetting conforms to the classic form of a “standards” approach, in that it requires an evaluative judgment relating to existing facts and facts that are to transpire. As discussed in the next section, conventional formulations of aiding and abetting require a finding of a requisite degree of culpability by the third-party in assisting another person to violate the law.¹⁰⁴ The standard evaluates whether a secondary participant acted culpably under the facts and circumstances. Such a standard does not proscribe conduct with bright-line precision, as in the case of a rules-based norm, but rather calls for judgment in its application regarding the degree of culpability and the significance of the assistance.¹⁰⁵

An aiding and abetting standard entails only conditional liability: the secondary actor is only liable if there is a primary violation of law by another—the so-called primary actor.¹⁰⁶ As a result, the correct application of aiding and abetting standards is largely retrospective. The assistance or complicity that is being discouraged becomes unlawful only after the primary violation occurs. The conditional nature of secondary liability detracts from the deterrence value of standards because the rational third party, in addition to assessing whether its own conduct would likely be viewed as assisting in another’s unlawful activity, will discount that

avored when there is “frequency of application in recurring fact scenarios” and utility associated with low “cost of learning the law”).

103. Schlag, *supra* note 95, at 385 (“Because the distinction between permissible and impermissible conduct is not fixed, but is case-specific, persons will be deterred from engaging in borderline conduct and encouraged to substitute less offensive types of conduct.”).

104. See *supra* Section II.A (discussing elements for aiding and abetting).

105. *Id.* As explained above, culpability and substantial assistance are required elements for establishing aiding and abetting liability.

106. *Id.*

assessment by both the probability of whether a violation will in fact occur (i.e., the primary actor will commit a violation) and whether the violation is likely to be detected (i.e., whether the primary actor's misconduct be detected and successfully prosecuted).¹⁰⁷

It is also possible to conceive of rules-based anti-complicity measures. Certification requirements are a good example. Such a requirement does not prohibit complicity *per se*, but rather imposes a direct obligation on a signatory that may be inconsistent with specific acts of complicity. For example, the signatory attests to having read the document and disclaims knowledge of facts that would lead you to believe that what is said in the document is not true.¹⁰⁸ Certification prevents someone after the fact from making the types of excuses complicit parties might be tempted to make: "I did not think it was my responsibility" or "I never bothered to share the information with others."

Several points can be made about this type of anti-complicity measure. A rules-based anti-complicity measure can indirectly arrest the potential for complicity by removing opportunities for deniability. Second, rather than being primarily retrospective in assessing conduct, rules are more likely to have a prospective effect in preventing conduct. A rule provides clear notice to an actor that certain conduct that might be highly correlated with unlawful conduct is itself prohibited, absent safeguards, regardless of whether some other actor's conduct is known to be unlawful. Finally, norms framed as rules that seek to deter complicity may cut more broadly than merely impeding complicit conduct. Rules may be formulated to diminish the risk of deliberate complicity as well as promote affirmative obligations that have the effect of impeding violations. Thus, anti-complicity rules may affirmatively contribute to compliance not only in terms of deterring complicity but in promoting compliance (i.e., encourage persons to act in a way that makes it harder for others to violate the law). In this sense, rules-based norms are far more likely to build a culture of compliance and accountability than standards alone, the application of which may be uncertain and cannot be fully evaluated except in hindsight.

These considerations are directly relevant in understanding the economics and behavioral logic of complicity. The economics of

107. The conditional nature of the standards-based approach to secondary liability diminishes its deterrent effect and this consequence is enhanced by behavioral considerations. If secondary parties systematically underestimate the likelihood of detection relating to their own assistance (over-optimism bias coupled with rationalization), the effectiveness of an aiding and abetting standard will be substantially weakened.

108. See 15 U.S.C. §7241 (2006) (requiring that principal officers certify each report filed under § 78m(a) or 78o(d) of Title 15); 17 CFR §240.13a-14 (2011) (for reports under § 13(a) of the Securities Exchange Act of 1934); see also 18 U.S.C. §1350 (2006) (requiring corporate officers to file a statement certifying that a report under this section fully complies with SEC requirements and that the information contained therein is accurate).

complicity is built around an understanding that regulating the conduct of third parties may be the most socially efficient means for achieving regulatory goals with respect to primary parties (i.e., primary parties such as reporting companies are more efficiently regulated through measures directed at third parties such as auditors and other gatekeepers and transactional counterparties). Although economics alone does not dictate whether rules or standards *a priori* are likely to be more successful as anti-complicity strategies, some factors might lead one to favor rules in some circumstances and standards in others.¹⁰⁹

Behavioral considerations are particularly relevant in understanding whether rules or standards are likely to be more effective in a given situation. If third parties are not terribly rational, suffer from bounded rationality, or are subject to any of a variety of behavioral biases in evaluating how their own conduct may contribute to the likelihood of violations by others, then rules rather than standards are likely more effective.¹¹⁰ Standards are most useful in preventing deliberate assistance to a primary violator (as opposed to assistance through acquiescence, indifference, or behavioral obtuseness) because this raises the specter of opportunistic circumvention of specific rules formulated to prevent specific activity by the secondary party.

III. THE EMERGENCE OF STANDARDS-BASED ANTI-COMPLICITY POLICIES AND *CENTRAL BANK*'S SHADOW

Make no mistake: the current anti-complicity standards regime administered by the SEC is functional; secondary actors are sanctioned with some frequency.¹¹¹ However, the question posed in this article is whether primarily relying on aiding and abetting liability standards, or variants thereof, is an optimal or even superior anti-complicity strategy in the securities law context.¹¹² As described in this section, the anti-complicity regime (grounded in aiding and abetting principles) is a

109. Korobkin, *supra* note 73, at 58 (“Under either approach, an honest analyst without preconceived conclusions must ultimately say that multiple considerations favor each type of legal form [rule or standard], and which form is most desirable will depend on which set of competing costs dominate in a particular fact-specific situation.”); *accord* Kaplow, *supra* note 95, at 562 (examining the desirability of each legal form by considering their legal costs).

110. *Cf.* Korobkin, *supra* note 73, at 56 (stating that “rules are . . . more likely to have a dynamic effect on social norms by encouraging people to behave in a socially desirable way”).

111. *See supra* Section II.B (exploring the liability of gatekeepers as secondary actors).

112. This section shows problems in applying standards built on elements relating to mental state and substantial assistance. These problems also serve to highlight that there are many kinds of complicity, whether by action or inaction, that are not subject to sanction but that could, if curbed, promote compliance with the law by others.

cumbersome system of many overlapping legal distinctions with uncertain application and somewhat arbitrary results. As in any fault-based standards system, each case entails a fact-intensive inquiry. A realistic assessment of the effectiveness of a standards-based regime as a source of deterrence rests not only on its successful application in particular cases, but more importantly, on its predictable application in a great range of cases in a way that affects the behavior of secondary actors. The discussion below identifies three basic reasons the current system may not be effective: (1) current doctrines regarding aiding and abetting standards do not capture significant forms of complicit conduct; (2) the *Central Bank* trilogy of Supreme Court decisions has made a muddle of the difference between primary and secondary liability; and (3) legislative fixes to securities statutes after *Central Bank*, though making the existing standards scheme more workable, have not fundamentally addressed the deficiencies of a standards-based approach.

This section begins with a brief overview of how the structure of complicity standards took shape under the securities laws. It then turns to the Supreme Court's watershed *Central Bank* decision and the eventual trilogy of cases that explore the relationship between complicity and damage remedies. While there may be sound policy considerations for questioning the utility of private damages actions based on complicity alone, the Supreme Court's result-oriented decisions do little to bring any principled understanding of anti-complicity policies. The section concludes with a brief discussion of post-*Central Bank* statutory reforms to show that the reforms, while correcting some problems, do not overcome the basic obstacles to the efficacy of placing undue reliance on standards alone as an anti-complicity strategy.

A. *The Evolution of Anti-Complicity Standards under Federal Securities Law*

The SEC is currently authorized to bring four different types of standards-based claims that can be used in combination for sanctioning secondary complicit conduct (i.e., conduct that is not itself an independent securities law violation), three of which entail some form of administrative proceeding.¹¹³ The fourth is a civil enforcement action, such as provided

113. The administrative proceedings that provide explicitly for aiding and abetting liability are the Securities Exchange Act § 15(a)(4)(E), 15 U.S.C. § 78o(a)(4)(E) (2006) (defining roles of broker-dealers and their associated persons), and the Investment Advisers Act § 203(e)(6), 15 U.S.C. § 80b-3(e)(6) (2006) (describing investment advisers and their employees). The SEC's authority to bring cease-and-desist proceedings against any person under § 21C of the Exchange Act extends to aiding and abetting securities law violations by any person "that is, was, or would be a cause of the violation, due to an act or

under Section 20(e) of the Exchange Act, which may be brought in federal court against any person.¹¹⁴

At the outset, it is important to correct a misimpression about legislative policy relating to complicity arising from *Central Bank*. While Congress did not create an express general civil (private damage or law enforcement) cause of action for aiding and abetting securities fraud violations,¹¹⁵ the statutory “omission” did not evidence a longstanding legislative policy disfavoring sanctioning persons complicit in securities law violations. Quite the opposite is true. Congress has consistently expanded policies favoring use of anti-complicity standards to discourage complicit conduct by third parties. Most of these provisions involved expanding liability in the administrative context and these developments occurred against a judicial landscape that already recognized private and government enforcement actions for aiding and abetting. The creation of express anti-complicity administrative remedies, as described below, evidences an unwavering trend in favor of expanded liability for complicity, a narrative quite different from that projected by the majority in *Central Bank*.¹¹⁶

Not surprisingly, standards were historically the preferred policy means for regulating complicity under federal securities law. Such an approach had well-developed criminal law antecedents¹¹⁷ and the alternative discussed here, namely a rules-based approach, did not exist as an established model. The original statutory provisions of the Securities Act and the Exchange Act contained limited anti-complicity provisions. Under the Securities Act, secondary parties, ranging from officers and directors to underwriters and accountants, are strictly liable (subject to due diligence defenses) under Section 11¹¹⁸ for material misstatements in registration statements. The Exchange Act involved a more conventional

omission the person knew or should have known would contribute to such violation” 15 U.S.C. § 78u-3(a) (2006).

114. Securities Exchange Act § 20(e), 15 U.S.C. § 78t(e) (Supp. IV 2010). The SEC may also bring direct claims that impose liability for deficient supervision by registered securities professionals, which is also standards-based.

115. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 164–65 (1994). This fact was hardly surprising. Because Congress did not create an express private cause of action for fraud under Exchange Act Section 10, it necessarily never considered doing so for aiding and abetting.

116. *See infra* text accompanying notes 122–41.

117. The general criminal law aiding and abetting violation was introduced into the U.S. Criminal Code in 1909. Act of Mar. 4, 1909 ch. 321, § 332, 35 Stat. 1152 (1909) (current version at 18 U.S.C. § 2 (2006)). *See generally* Baruch Weiss, *What Were They Thinking?: The Mental States of the Aider and Abettor and the Causer under Federal Law*, 70 FORD. L. REV. 1341, 1344–48 (2002) (discussing the historical implementation of aiding and abetting doctrine).

118. 15 U.S.C. § 77k (2006).

invocation of liability standards under both Sections 9¹¹⁹ and 18¹²⁰ for those causing violations, which differs only slightly from formulations based on aiding and abetting.

Civil aiding and abetting under the securities laws had its foundation in judicial reasoning rather than in express legislative language. The SEC's ability to proceed against aiders and abettors civilly was recognized fairly early and long before *Central Bank*.¹²¹ Recognition of private actions for aiding and abetting securities fraud followed closely on the heels of the recognition of the implied private right of action under Rule 10b-5. By the time *Central Bank* had been decided, eleven U.S. Courts of Appeals—every circuit to have addressed the issue—agreed that private damages claims for aiding and abetting were properly implied under Rule 10b-5.¹²²

While courts led the way in introducing aiding and abetting civil liability to the securities laws, Congress was quick to follow by establishing injunctive and administrative standards-based anti-complicity sanctions. Indeed, one of the most striking aspects of congressional policy has been its consistent expansion of standards-based secondary liability. The SEC was first expressly empowered to seek administrative and injunctive sanctions where a person “aided [or] abetted” violations by another person through amendments to the Investment Advisers Act in 1960.¹²³ The amendments codified SEC practice in sanctioning persons associated with investment advisers in connection with violations of the Investment Advisers Act, thereby removing any doubts in this regard as to the SEC's authority.¹²⁴ The language was modeled after the general

119. 15 U.S.C. §78i (2006).

120. 15 U.S.C. §78r(2006).

121. *See, e.g.*, SEC v. Gen. Refractories Co., 400 F.Supp. 1248, 1256–57 (D.D.C. 1975) (issuing an injunction in favor of the SEC in a case against a fire brick distributor); SEC v. Manor Nursing Ctrs., Inc., 340 F. Supp. 913, 934 (S.D.N.Y. 1971) (depicting an anti-fraud action brought by the SEC against a nursing home company), *aff'd in part and rev'd in part on other grounds*, 458 F.2d 1082 (2d Cir. 1972); SEC v. Scott Taylor & Co., 183 F. Supp. 904, 910 n.12 (S.D.N.Y. 1959) (enjoining defendants against using interstate commerce or mail to sell its corporation's stock); SEC v. Timetrust, Inc., 28 F. Supp. 34, 43 (N.D. Cal. 1939) (denying motions to dismiss by defendants in antifraud suit brought by SEC).

122. *Central Bank*, 511 U.S. at 192 (Stevens, J. dissenting). These developments are discussed in Section II.B. above.

123. Investment Advisers Act (IAA), Pub. L. No. 86-750, §§ 203(e), 209(e), 74 Stat. 885, 886–87 (1960) (codified as amended at 15 U.S.C. §§ 80b-3(e), 9(e) (2006)).

124. H.R. REP. NO. 86-2179, at 8 (1960) (“It is also designed to make it clear that persons associated with an investment adviser may be liable in civil and administrative proceedings for violation of the prohibitions which by their terms apply only to investment advisers.”); accord S. REP. NO. 86-1760, at 9 (1960) (amending the IAA to “prohibit fraud by those advisers exempt from registration” and to “extend criminal liability to include a willful violation of a rule or order of the Commission”). Contemporaneously, similar amendments were proposed by the SEC for the Securities Act and the Exchange Act, but those amendments, which had engendered industry concerns regarding private litigation

criminal law provision for aiding and abetting.¹²⁵ This approach was extended to administrative proceedings against broker-dealers and their associated persons three years later as part of the Securities Acts Amendment of 1964.¹²⁶ Although the scant legislative history relating to these administrative remedies does little to explicate the relevant content of the standards,¹²⁷ the legislative intent parallels earlier broader amendments to the Investment Advisers Act¹²⁸ that codified existing practice relating to the sanctioning of securities professionals.¹²⁹

In 1990, Congress again expanded the standards-based remedies for complicity under federal securities law by giving the SEC the ability to

ramifications, died while awaiting a conference after a superseding legislative mandate directed the SEC to prepare a major study of U.S. securities markets that culminated in the Securities Act Amendments of 1964. See Peter A.K. Reese, *Securities Legislation of 1960 (Part I)*, 17 BUS. LAW 412 n.4, 417 n.26 (1962) (exploring the implications of those amendments).

125. Compare Investment Advisers Act Section 209(d), 15 U.S.C. § 80b-9(d) (2006) (stating “[w]hensoever it shall appear to the Commission that . . . any person has aided, abetted, counseled, commanded, induced or procured . . .”), with the U.S. Criminal Code’s general aiding and abetting provision, 18 U.S.C. § 2(a) (2006) (stating “[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal”). This connection was made explicit in the Senate Report accompanying the legislation:

This section of the bill would also make it clear that the Commission may obtain an injunction against any person who is aiding, abetting, or inducing another person to violate the act. The addition to the injunction section does not limit the application of the criminal aiding and abetting statute of the United States Code (18 U.S.C. [§] 2). Rather the amendment borrows the concepts of aiding and abetting from the criminal law and seeks to insure that persons will be liable in administrative actions by the Commission, as well as in criminal actions.

S. REP. NO. 86-1760, at 8–9 (1960).

126. Pub. L. No. 88-467, § 6(b), 78 Stat. 565, 571 (1960) (amending Section 15(b) of the Exchange Act of 1934) (codified as amended at 15 U.S.C. § 78o(b)(4)(E) (2006)).

127. But see Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007, 1035–36 (1983) (indicating that Congress appeared to reject evolving case law in the civil damage actions as a model and appeared to endorse imposition of secondary liability on a showing of mere negligence).

128. See SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, pt. 2, at 160 (1963) (showing intent of the Congress regarding the securities market under the Acts); see also Task Force on Broker-Dealer Supervision and Compliance of the Committee on Federal Regulation of Securities, *Broker-Dealer Supervision of Registered Representatives and Branch Office Operations*, 44 BUS. LAW. 1361, 1364 (1989) (discussing the legislative history of Section 15(b)(4)(E)).

129. William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 321–22 n.45 (1989) (citing *Nees v. SEC*, 414 F.2d 211, 220–21 (9th Cir. 1969)).

institute administrative cease-and-desist proceedings.¹³⁰ A cease-and-desist proceeding is administrative in nature, but unlike administrative aiding and abetting proceedings, the SEC may commence C&D proceedings against any person and not merely securities professionals (i.e., registrants and their associated persons). Thus, the class of potential respondents in C&D proceedings is as broad as the potential class of defendants that can be sued in SEC enforcement actions.¹³¹

The new C&D remedy also liberalized the substantive theories to establish complicity by requiring a lesser degree of culpability than in civil or administrative aiding and abetting proceedings. A C&D order may be issued against any person “that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation . . . of the same provision, rule or regulation.”¹³² The relevant culpability standard encompasses negligent contributory conduct (at least in cases of non-scienter-based primary violations), a standard that is more encompassing than recklessness¹³³—the prevailing culpability standard in administrative and civil proceedings. In addition, the secondary actor’s offending conduct can stem from omissions as well as affirmative acts of assistance.¹³⁴

A C&D order is similar to a civil injunction, but not in cases where the person violates the order after it is entered.¹³⁵ A civil injunction violation is punishable in a criminal or civil contempt proceeding, while a C&D order violation requires the SEC to seek a court order compelling adherence to

130. See Securities Act Section 8A, 15 U.S.C. § 77h-1 (2006) (granting the SEC the authority to issue C&D order preventing law violators from continuing to violate or violating in the future the same provision); Securities Exchange Act Section 21C, 15 U.S.C. § 78u-3 (2006) (providing the SEC with the authority to bring C&D proceedings as part of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990).

131. Compare 15 U.S.C. § 78u-3(a) (2006) (granting SEC’s authority to issue C&D orders), with 15 U.S.C. § 78u(a) (2006) (showing the language describing the jurisdictional scope as to “persons” who can be subject of C&D proceedings substantially tracks language of the jurisdictional scope of “persons” who can be subject to an SEC investigation).

132. 15 U.S.C. § 77h-1(a) (2006); 15 U.S.C. § 78u-3(a) (2006); see H.R. REP. NO. 101-616, at 5 (1990) (showing the legislative history relating to creation of the C&D power emphasized that the new remedial authority would provide the SEC with a greater range of flexibility to bring about compliance without burdening courts).

133. See *KPMG, LLP v. SEC*, 289 F.3d 109, 118–20 (D.C. Cir. 2002) (upholding the SEC’s determination that the statutory culpability standard for C&D orders “invokes . . . classic negligence language”).

134. This is explicit from the statutory language which provides that an order may be entered against any person, in addition to a person violating the law, where that person “is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation . . .” 15 U.S.C. § 78u-3(a) (2006).

135. KIRKPATRICK & LOCKHART, PRESTON GATES ELLIS LLP, *THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES* 189–91 (2007).

the order.¹³⁶ In addition, entry of a C&D against a respondent does not trigger the same disclosure requirements as a civil injunction.¹³⁷ For these reasons, practitioners generally regard a C&D order as a less severe form of sanction. In one respect, this perception has changed. While penalties could not originally be obtained directly in a C&D proceeding (i.e., a parallel civil proceeding would need to be instituted) that limitation was overcome in the Dodd-Frank Act.¹³⁸

Finally, pursuant to Rule 102(e), the SEC has exercised administrative authority to censure, suspend, or disbar professionals such as attorneys and accountants from appearing or practicing before the SEC due to professional misconduct.¹³⁹ The authority was not grounded originally in statute, but rather in the SEC's general rulemaking authority and the agency's inherent authority over its own processes.¹⁴⁰ Nevertheless, Congress expressly ratified such agency authority as part of the Sarbanes-Oxley Act of 2002¹⁴¹ to resolve doubts raised in judicial decisions regarding the scope of the SEC's authority.¹⁴² Rule 102(e) itself represents yet another standards-based mechanism for policing complicit conduct, in this case conduct of lawyers and accountants who act as gatekeepers.

Generally, the SEC has stayed its hand relating to the sanctions against attorneys, unless they are based on a separate adjudication such as adverse findings in a criminal or civil proceeding.¹⁴³ Addressing the

136. *Id.*

137. 17 C.F.R. § 229.401(f) (2011).

138. *See infra* note 202.

139. 17 C.F.R. § 201.102(e) (2011); see Norman S. Johnson & Ross A. Albert, "Déjà Vu All Over Again": The Securities and Exchange Commission Once More Attempts to Regulate the Accounting Profession Through Rule 102(e) of Its Rules of Practice, 1999 UTAH L. REV. 553, 553 n.2 (noting no fundamental differences between current rule and its predecessor).

140. See Amendment to Rule 102(e) of the Commission Rules of Practice, Securities Act Release No. 7,593, 63 Fed. Reg. 57,164 (Oct. 26, 1998) (noting Commission's purpose in adopting Rule 102(e) was to protect the integrity and quality of its system of securities regulation and, by extension, the interests of the investing public). Rule 102(e) exists as a means to ensure that those professionals on whom the Commission heavily relies act "diligently and with a reasonable degree of competence." *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979). See also Johnson & Albert, *supra* note 139, at 559 (describing from a critical perspective bases for the SEC's rule prior to its amendment in 1998).

141. Sarbanes-Oxley Act, Pub. L. No. 107-204, § 602, 193 Stat. 745 (2002) [hereinafter SOX] (codified at 15 U.S.C. § 78d-3 (2006)).

142. See *Checkovsky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994); *Checkovsky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998).

143. See Paul Gonson, *The 1998 Amendment to SEC Rule 102(e) Will Withstand Judicial Scrutiny*, 1999 UTAH L. REV. 609, 611 (describing the Commission's use of "piggybacking" on previous forum's findings of violation); see also, e.g., *In re Copeland*, Exchange Act Release No. 61,584, 2010 WL 675926 (Feb. 25, 2010) (issuing a suspension under Rule 102(e) based on a conviction of wire fraud—a felony involving moral turpitude—and having been disbarred from the practice of law).

controversial application of the rule to accountants, the SEC amended Rule 102(e) in 1998 to clarify the level of culpability required for an accountant to be disciplined under the rule.¹⁴⁴ In addition to intentional, knowing, or reckless conduct that results in a violation of applicable professional standards, proceedings can also be based on either a single, highly unreasonable act under professional standards or a pattern of unreasonable professional conduct.¹⁴⁵

B. The Pre-Central Bank Aiding and Abetting Standards Sinkhole

In addition to the expansive administrative standards-based anti-complicity regime that took root before *Central Bank*, there existed a substantial judicially-created body of law relating to aiding and abetting. The issue posed by aiding and abetting standards was not whether the cause of action was judicially cognizable, but rather the content of the relevant standards. As discussed below, the law of aiding and abetting under the securities laws was in a chaotic state prior to *Central Bank* because the various federal courts of appeals articulated different substantive approaches in applying aiding and abetting standards.¹⁴⁶ Indeed, as originally cast on certiorari, the *Central Bank* case was to be a vehicle for resolving circuit splits regarding controlling legal standards. This subsection explores the lack of clarity and the inherent structural limitations in a standards-based approach to demonstrate fundamental weaknesses in exclusively relying on a standards-based regime under the securities laws.

Before *Central Bank*, nearly all courts analyzing aiding and abetting claims applied a common three-part test: first, that a primary violation of the Exchange Act had occurred; second, that the aider and abettor had awareness or knowledge of the violation and their assistance to the primary violator (the culpability prong); and third, that the aider and abettor substantially assisted in the primary violation.¹⁴⁷

144. See *supra* note 140 (noting the purpose of the Amendment); see generally Johnson & Albert, *supra* note 136 (providing a comprehensive overview of Rule 102(e) amendments and the role of accountants under securities laws).

145. See 17 C.F.R. § 201.102(e)(1)(iv) (2011) (stating that improper professional conduct requires more than “mere” or “simple” negligence); see also Gonson, *supra* note 139, at 615 (discussing the negligence standard in the 1998 amendment).

146. Justice Stevens’ dissenting opinion in *Central Bank* noted that certain questions as to what types of conduct rose to a level of substantial assistance and what state of mind was required to generate aiding and abetting liability had “engendered genuine disagreement in the Courts of Appeals.” *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 194 (1994) (Stevens, J., dissenting).

147. *Id.*; see also David S. Ruder, *The Future of Aiding and Abetting and Rule 10b-5 after Central Bank of Denver*, 49 BUS. LAW. 1479, 1479–80 (1994) (listing elements of aiding and abetting and citing appropriate cases). Even after *Central Bank*, courts adhere to

The existence of a primary violation, the first of the three elements, has never been controversial. Aiding and abetting, whether criminal or civil, presupposes a primary violation, namely the improper conduct that the secondary participant aids and abets.¹⁴⁸ However, this feature also embodies a common limitation in standards-based anti-complicity regimes: secondary liability is derivative in nature. The third party's conduct will result in liability only in conjunction with the primary liability of another and then only if the third party provides culpable assistance. Despite the common law foundation of aiding and abetting liability in tort and criminal law,¹⁴⁹ courts were sharply divided on what constitutes culpable assistance.¹⁵⁰

1. The Assistance Component in Complicity

Assistance, rather than agreement, is the nexus that connects an alleged aider and abettor to the primary violation.¹⁵¹ Assistance to the

this formulation. *See, e.g., SEC v. Lybrand*, 200 F. Supp. 2d 384, 399 (S.D.N.Y. 2002) (listing the three pre-*Central Bank* factors for establishing aider and abettor liability).

148. *See Standefer v. United States*, 447 U.S. 10, 20 (1980) (distinguishing between conviction of aider and abettor for a crime, notwithstanding the principal's acquittal in a separate proceeding, and the requirement that commission of a crime is a predicate for convicting a person of aiding and abetting).

149. *See* Joel S. Feldman, *The Breakdown of Securities Aiding and Abetting Liability: Can a Uniform Standard be Resurrected?*, 19 SEC. REG. L.J. 45, 47–48 (1991) (arguing that early court decisions implying private rights of actions for damages against aider and abettors relied on both criminal law precedent and the common law principles); *see also* David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 620–27 (1972) (describing emergence of aiding and abetting concepts under the securities laws). *Compare SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Cal. 1939) (showing criminal law antecedents), *with Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966) (showing civil law antecedents).

150. *See Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980) (“Although this list of prerequisites has become commonplace, the exact content of the rather vague phrases, especially ‘knowledge’ and ‘substantial assistance,’ is still being delineated by the courts.”); *see also* Gregory E. Van Hoey, Note, *Liability for “Causing” Violations of the Federal Securities Laws: Defining the SEC’s Next Counterattack in the Battle of Central Bank*, 60 WASH. & LEE L. REV. 249, 257 (2003) (discussing courts’ slightly different approaches to formulating aiding and abetting liability). Though each requirement can be a source of confusion, they are sometimes even analyzed together.

151. *See* Richard C. Mason, *Civil Liability for Aiding and Abetting*, 61 BUS. LAW. 1136, 1138 (2006) (“Aiding and abetting does not require any agreement, but rather assistance given to the principal wrongdoer.”); *see also Halberstam v. Welch*, 705 F.2d 472, 477 (D.C. Cir. 1983) (discussing common law tort of aiding and abetting); *Pinkerton v. United States*, 328 U.S. 640, 649 (1946) (Rutledge, J., dissenting) (noting that under criminal law, “[t]he gist of conspiracy is the agreement; that of aiding, abetting or counseling is in consciously advising or assisting another to commit particular offenses, and thus becoming a party to them . . .”). The assistance must not only be substantial, but also, as discussed *infra*

primary violator's misconduct must be "substantial," one of several limitations in traditional aiding and abetting standards designed to prevent secondary actor liability for conduct merely incidental to a primary violation.¹⁵² In determining whether assistance is "substantial," it is necessary to consider the nature and quality of the assistance provided. Assistance that is essential or unusual is not required. Assistance that is enormously significant to the accomplishment of a violation is obviously sufficient to meet this standard, whereas assistance of a seemingly ministerial or generic character may not rise to the level of substantial assistance.¹⁵³ Because "substantial" is an inherently open-ended standard, courts lack determinate guidance as to what conduct rises to the level of substantial assistance.¹⁵⁴

Courts, both pre- and post-*Central Bank*, have indicated that substantial assistance should be viewed as a form of proximate causation.¹⁵⁵

Section III.B.3, culpable.

152. Although courts have insisted that a clear line exists between substantial and insubstantial assistance, the precise bounds are indefinite. *See* *Graham v. SEC*, 222 F.3d 994, 1004 (D.C. Cir. 2000) (rejecting defendant's argument that her conduct was only ministerial in nature and thus could not rise to the necessary level of substantial assistance). *Compare* *SEC v. Treadway*, 430 F. Supp. 2d 293, 339 (S.D.N.Y. 2006) ("[M]ere awareness and approval of the primary violation is insufficient to make out a claim for substantial assistance."), *with* *J.P. Morgan Chase Bank v. Winnick*, 406 F. Supp. 2d 247, 256 (S.D.N.Y. 2005) (stating that "[a] defendant provides substantial assistance only if [she] affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables [the fraud] to proceed").

153. RESTATEMENT (SECOND) OF TORTS § 876(b) cmt. d (1979) ("In determining this, the nature of the act encouraged, the amount of assistance given by the defendant, his presence or absence at the time of the tort, his relation to the other and his state of mind are all considered.").

154. *See* Brief for Petitioner at 17, *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (No. 92-854), 1993 WL 407327 ("Because substantial assistance of a primary violation is not the conduct prohibited by the statute, courts are entirely without guidance as to who may be subjected to liability.").

155. Before *Central Bank*: *see, e.g.*, *Bloor v. Carro*, 754 F.2d 57, 62 (2d Cir. 1985) ("In alleging the requisite 'substantial assistance' by the aider and abettor, the complaint must allege that the acts of the aider and abettor proximately caused the harm to the corporation on which the primary liability is predicated."); *Armstrong v. McAlpin*, 699 F.2d 79, 92 (2d Cir. 1983) (requiring the aider and abettor's substantial assistance be a proximate cause of the primary harm); *Edwards Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980) (adopting the proximate causation requirement); *see also* Carrie E. Goodwin, Note, *Central Bank v. First Interstate Bank: Not Just the End of Aiding and Abetting Under Section 10(b)*, 54 WASH. & LEE L. REV. 1387, 1395-96 (1995) (discussing further the implications of *Central Bank*).

After *Central Bank*: *see, e.g.*, *SEC v. Apuzzo*, 758 F. Supp. 2d 136, 150 (D. Conn. 2010) (requiring proximate causation to determine substantial assistance); *SEC v. Treadway*, 430 F. Supp. 2d 293, 339 (S.D.N.Y. 2006) ("The aider and abettor's substantial assistance must be a proximate cause of the primary violation."). Despite the fact that causation language is rooted in pre-*Central Bank* case law, courts continue to regard it as "controlling and relevant" to actions currently brought by the SEC. *SEC v. DiBella*, 587

But this analogy is more likely a source of confusion rather than guidance. As the *Restatement of Torts* makes clear in discussing civil liability predicated on aiding and abetting, substantial assistance is *not* a causation concept concerning initiation or direction of the acts that constitute the violation (indeed activity of the latter sort might be more relevant in showing primary liability).¹⁵⁶ Rather, substantial assistance is conduct that contributes in some fashion to unlawful conduct committed by another.¹⁵⁷ As the *Restatement (Second)* explains, the assessment is driven by a facts and circumstances analysis.¹⁵⁸ Naturally, when undertaking this fact-intensive review, courts tend to focus on the specific acts of an alleged aider and abettor—a hair-splitting process that has forced adjudicators to focus on minuscule differences with somewhat arbitrary results.¹⁵⁹ Immediately prior to *Central Bank*, the Seventh Circuit adopted the most restrictive view of substantial assistance in private actions for damages: the assistance prong could only be satisfied by acts that would by themselves constitute a primary violation.¹⁶⁰ With such a restrictive approach, many

F.3d 553, 566 n.9 (2d Cir. 2009).

156. RESTATEMENT (SECOND) OF TORTS § 876(b) (1979).

157. *Id. Accord* Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 800 (3d Cir. 1978), *cert. denied*, 439 U.S. 930 (1978) (citing RESTATEMENT (FIRST) OF TORTS in a securities fraud aiding and abetting action). For a philosophical discussion of causation principles surrounding criminal accomplice liability, see Michael S. Moore, *Causing, Aiding, and the Superfluity of Accomplice Liability*, 156 U. PA. L. REV. 395 (2007) (containing a philosophical discussion of causation principles surrounding criminal accomplice liability). Professor Moore's skepticism regarding the need for accomplice liability, however, is not ultimately persuasive.

158. RESTATEMENT (SECOND) OF TORTS § 876(b) cmt. d. (1979).

159. *See* SEC v. Patel, Fed. Sec. L. Rep. (CCH) ¶ 94,613, 2008 WL 782483 (D.N.H. Mar. 24, 2008) (providing examples of conduct rising to the level of substantial assistance). Comparing the facts before the court with another SEC action (SEC v. Druffner, 353 F. Supp. 2d 141 (D. Mass. 2005)), the *Patel* court focused on actions such as “approving,” “authorizing,” “failing to stop,” “provid[ing],” “propos[ing],” and “agreeing” amongst others. *Patel*, 2008 WL 782483, at *11. *See also* SEC v. Pimco Advisors Fund Mgmt., 341 F. Supp. 2d 454, 466 (S.D.N.Y. 2004) (focusing on the defendants’ “facilitation” of the fraud). After a court has determined that such acts do, by their nature, rise to a level of substantial assistance, the determination can seem somewhat conclusory. *See, e.g.,* SEC v. Graham, 222 F.3d 994, 1004 (D.C. Cir. 2000) (asserting that there was “no doubt” that the defendant, an associated person of a broker-dealer, “did play a role—and a substantial one” in assisting the fraud when executing trades on behalf of a principal).

160. *See* Schlifke v. Seafirst Corp., 866 F.2d 935, 947 (7th Cir. 1989) (discussing that a non-primary violator must have taken part in a manipulative or deceptive act for secondary liability to stick); LHLC Corp. v. Cluett, Peabody & Co., Inc., 842 F.2d 928, 932–33 (7th Cir. 1988), *cert. denied*, 488 U.S. 926 (1988) (requiring that if a primary violator carries out a fraud and defendant kept silent, plaintiff must prove the defendant “had a legal duty to speak”); Barker v. Henderson, 797 F.2d 490, 495 (7th Cir. 1986) (noting that “each person alleged to be an aider, abettor, or conspirator” must have “himself committed one of the ‘manipulative or deceptive’ acts or otherwise met the standards of direct liability” for a primary violation).

forms of complicit conduct would evade sanction.¹⁶¹ In contrast, the SEC has applied a liberal standard in administrative proceedings to determine whether assistance is substantial.¹⁶²

Substantial assistance has received varying treatment in the context of a secondary actor's inaction. Inaction may facilitate unlawful conduct by failing to prevent or disrupt schemes that entail violations.¹⁶³ Even after the enactment of PSLRA provisions designed to reaffirm the SEC's ability to bring aiding and abetting actions, ambiguities about inaction as sufficient substantial assistance remained, largely because Congress failed to define the term in the Act.¹⁶⁴ Substantial assistance generally has been viewed as implicitly requiring affirmative acts of assistance, reflecting concerns about indirectly imposing expansive new duties on secondary parties under the securities laws.¹⁶⁵ But a secondary party's failure to act may enable another to commit a securities violation, as reflected in the facts of *Central Bank*.¹⁶⁶ Prior to *Central Bank*, some courts of appeals flatly rejected the notion that a failure to act might be deemed substantial assistance, absent a duty to disclose.¹⁶⁷ However, other circuits held that inaction, even absent a duty

161. See Feldman, *supra* note 149, at 70–71 (describing the Seventh Circuit's restrictive approach as giving expression to the court's underlying "skepticism" regarding aiding and abetting liability).

162. *In re Performance Analytics, Inc.*, Exchange Act Release No. 46,081, 2001 WL 1148155 (June 17, 2002) ("The Commission need not show that the assistance rendered by the aider and abettor was 'the sole cause or the principal cause; it need only be one of the causes.'") (internal citations omitted); *In re Russo Securities*, Exchange Act Release No. 39,181, 1997 WL 603786 (Oct. 1, 1997) ("[T]he harm must be a direct and foreseeable result of the alleged assistance.").

163. See Feldman, *supra* note 149, at 59–66 (highlighting significant judicial disagreement regarding status of inaction as substantial assistance).

164. See Van Hoey, *supra* note 150, at 259–60 (citing Ruder, *supra* note 143, at 1484–85) (encouraging Congress to act on the issue)). Compare SEC v. Apuzzo, 758 F. Supp. 2d 136, 152–53 (D. Conn. 2010) (agreeing to send but not actually sending false audit confirmation letter is not substantial assistance) and Patel, 2008 WL 782483, at *11–12 (holding that a chief financial officer did not provide substantial assistance to misleading financial reporting because of his awareness of improprieties in preparing the financial statements, which he did nothing to correct because his conduct was not "affirmative" in nature), with SEC v. Druffner, 353 F. Supp. 2d 141, 151 (D. Mass. 2005) (finding that a branch office manager's approval of additional account numbers, authorization of the processing of transactions, and failure to stop known fraudulent conduct by sales representative was sufficient to show affirmative conduct) and SEC v. Espuelas, 698 F. Supp. 2d 415, 433 (S.D.N.Y. 2010) (holding that knowledge and failure to record a transaction is sufficient for substantial assistance).

165. See cases cited *supra* note 152.

166. *Central Bank*, *supra* note 1, at 167 ("Central Bank agreed to delay independent review of the [misleading] appraisal until the end of the year, six months after the June 1988 closing on the bond issue.").

167. See, e.g., *Schatz v. Rosenberg*, 943 F.2d 485, 496–97 (4th Cir. 1991) (holding that in the absence of a duty to disclose primary violator's action, a defendant's inaction cannot constitute substantial assistance); *Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 927 (2d Cir.

to disclose, might be sufficient if motivated by intent to facilitate a primary violation.¹⁶⁸ The treatment of inaction illustrates one of the deficiencies of a standards-based approach to complicity. An overly expansive approach does not provide secondary actors with sufficient notice of the circumstances in which inaction is prohibited.¹⁶⁹ A restrictive approach, rather than encouraging secondary parties to act proactively or to disassociate from the primary actor's scheme, insulates cooperative complicit behavior (behavior such as declining to react to red flags, avoiding awkward inquiries, or other forms of passive assistance) from liability.

2. The Culpability Component of Complicit Assistance

Under the standards approach to complicity, assistance by a secondary party that has the effect of aiding a primary violator's unlawful conduct, absent culpability by the secondary party, is not sufficient to trigger

1980) (noting inaction can only create aiding and abetting liability with there is a conscious or reckless violation of an independent duty to act).

168. See, e.g., *Schneberger v. Wheeler*, 859 F.2d 1477, 1481 (11th Cir. 1988), *cert. denied*, 490 U.S. 1091 (1989) (holding that there must be a "mix of scienter and participation sufficient for aider and abettor liability under [S]ection 10b-5"); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303–04 (6th Cir. 1987), *cert. denied*, 483 U.S. 1006 (1987) ("The plaintiffs must show that the silence of the accused aider and abettor 'was consciously intended to aid the securities law violation,' and must prove either a culpable state of mind, or conduct from which a culpable state of mind can be inferred.") (citing *SEC v. Washington Cnty.*, 676 F.2d 218, 224 (6th Cir. 1982)); *Metge v. Baehler*, 762 F.2d 621, 625 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 & 474 U.S. 1072 (1986) (noting that "inaction can be a proper basis for liability under the substantial assistance test"); *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 800 (3d Cir. 1978) (noting that inaction, however, may provide a predicate for liability where the plaintiff demonstrates that the aider-abettor *consciously* intended to assist in the perpetration of a wrongful act) (emphasis in original); *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975) ("When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved.").

169. For example, some argued in the pre-*Central Bank* era, that liability for inaction was particularly pernicious because secondary actors lacked reasonable notice regarding when they should or should not act, absent a well-recognized duty to act. See Patrick J. McNulty & Daniel J. Hanson, *Liability for Aiding and Abetting by Silence or Inaction: An Unfounded Doctrine*, 29 TORT & INS. L.J. 14, 17 (1993) (arguing that "the tort of aiding and abetting by silence should be abandoned in cases involving securities violations and economic loss, and that a rule based on breach of duty of disclosure should be substituted in its place"); see also Ruder, *supra* note 145, at 641–44 (expressing criticism of aiding and abetting by inaction). While legal arguments against secondary actor liability for inaction generally rely on the absence of any independent duty or lack of fair notice to the secondary actor, an entirely different policy response might encourage bright-line rules that induce action by secondary actors in certain contexts where secondary actors otherwise might remain inactive. Such an approach avoids potential concerns regarding fair notice to secondary parties.

liability. Culpability in this sense stems not from the act of assistance itself, but from a voluntary decision to provide such assistance in a context where the secondary party should have recognized grounds for withholding such assistance. Culpable complicity turns on two closely-related considerations relating to the secondary party's mental state: the nature of the knowledge that makes assistance potentially blameworthy (i.e., knowledge or awareness as to what facts), and the required degree of fault or blameworthiness by the secondary party.

As to the nature of the knowledge, courts were notably unsuccessful prior to *Central Bank* in articulating a stable consensus regarding what subjective state of mind was required for aiding and abetting liability. Courts focused on two related aspects of the secondary participant's mental state: (a) awareness or knowledge regarding the wrongfulness of the primary violator's conduct, and/or (b) awareness or knowledge of the relationship between the aider and abettor's assistance and the primary violator's misconduct. Some read this two-tiered approach as a two-part mental state requirement, namely that the violator have knowledge or awareness of the wrongfulness of the primary violator's conduct and knowledge of their role in assisting the primary violation.¹⁷⁰

Some courts suggested that it was knowledge of the specific primary violation,¹⁷¹ while others suggested awareness of unlawfulness alone might be sufficient.¹⁷² An actual knowledge standard potentially imposes a very high mental state standard. For example, in cases of securities fraud where a primary violator's misconduct is premised on recklessness, the actual knowledge standard (if applied literally) would require proof that the aider and abettor had even greater knowledge of the primary violation than the primary violator (where recklessness generally suffices¹⁷³) in order for

170. While conventional formulations have typically blended the mental state requirements of assistance and culpability, mental state and assistance are treated as distinct elements for purposes of this discussion.

171. See, e.g., *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1046 (11th Cir. 1986) (finding liability where aider abettor is aware of a violation); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974) *cert. denied*, 420 U.S. 908 (1975) (noting liability where the aider or abettor is aware of the violation); see also RESTATEMENT (SECOND) OF TORTS § 876(c) (1979) (denoting general liability for third party assisting tortious acts). While specific intent to aid the primary violator's unlawful objectives is not required, such intent would undoubtedly satisfy virtually any court's standard.

172. See, e.g., *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir. 1980), *cert. denied*, 449 U.S. 919 (1980) (discussing aiding and abetting liability in an administrative action).

173. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007) (citing *Ottmann v. Hanger Orthopedic Grp., Inc.*, 353 F.3d 338, 343 (4th Cir. 2003) and its collection of citations) (reserving the issue for future decision but noting "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required").

liability to attach.

An alternative approach emphasized the need to inquire into whether the person aiding and abetting another appreciated his or her role in providing assistance to the primary violator.¹⁷⁴ Such a standard is arguably a more demanding mental state requirement: it requires more detailed knowledge of the relationship between the actor's assistance and the primary violator's unlawful or tortuous conduct that the primary violator might not share with the secondary party. The stringency of this standard, as in the case of other mental state standards, varies depending on whether knowledge means actual knowledge or encompasses imputed mental states based on recklessness.

A third approach looked to the aider and abettor's intent or purpose in providing assistance. Under criminal law standards, aiding and abetting frequently is viewed (under the so-called *Peoni* standard¹⁷⁵) as requiring more than mere knowledge and something approaching intent. Few courts have discussed the mental state for civil aiding and abetting as an intent requirement. A notable exception is Judge Friendly's opinion in *IIT v. Cornfeld*¹⁷⁶ in which Judge Friendly expressly invoked *Peoni* as the guiding principle in civil actions.¹⁷⁷ Judge Friendly's position, if applied literally, could be viewed as requiring a quasi-criminal aiding and abetting intent standard, a standard that would constitute an unusually high hurdle in the civil or administrative context.

The other aspect, namely the requisite degree of culpability, received enormous judicial attention before *Central Bank* and the history is closely intertwined with the establishment of scienter standards in fraud actions.¹⁷⁸ As previously noted, the prevailing view among the courts of appeals, both before and after the PSLRA, required some form of recklessness to establish the requisite scienter for fraud by a primary violator.¹⁷⁹ Prior to *Central Bank*, the requisite degree of culpability for aiding and abetting liability frequently mimicked scienter standards applied in the securities fraud context, although, as discussed below, a number of courts of appeals

174. See, e.g., *Zabriskie v. Lewis*, 507 F.2d 546, 554 (10th Cir. 1974) (noting that an aider or abettor must have knowledge of their role in furthering the primary violation).

175. *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938) (quoted in *Nye & Nissen v. United States*, 336 U.S. 613, 619 (1949)). Even in the criminal realm the meaning of the *Peoni* standard and whether it actually reflects good law is itself subject to debate. See generally Weiss, *supra* note 117, at 1375–76 (classifying cases into six categories along a spectrum of mental states).

176. 619 F.2d 909 (2d Cir. 1980).

177. The *Peoni* formulation has neither been widely embraced nor even noticed by most courts, although it is echoed in isolated decisions. See, e.g., *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 36 (D.C. Cir. 1987) (expressing support for the *Peoni* formulation).

178. Indeed, the seminal Supreme Court precedent on fraud-based scienter is an aiding and abetting case. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193–94 n.12 (1976).

179. See *supra* note 173.

imposed even more demanding standards.

Recklessness was accepted by all courts (as discussed below) in at least some circumstances as satisfying the requisite mental state for finding secondary culpability. But within this broad consensus there appeared widely different approaches as to the circumstances in which recklessness might be deemed sufficient. Some courts adhere to the view that recklessness was generally sufficient,¹⁸⁰ while others held that recklessness was sufficient only in special circumstances.¹⁸¹

In the *Central Bank* case, which was resolved on other grounds as noted, the SEC urged the Supreme Court to adopt a general standard of recklessness in all cases of affirmative assistance.¹⁸² Although the nature of recklessness for aiding and abetting may have a strong affinity to the type of recklessness required in cases of fraud, the purpose of the recklessness requirement in each context differs.¹⁸³ For aiding and abetting, recklessness is used to establish the requisite degree of association between the aider and abettor's assistance and the primary violation, while in the case of civil fraud, it establishes the requisite culpability for intent to defraud.

Courts, however, have also embraced two other approaches, each of which depended on the presence of special facts.¹⁸⁴ In one approach, courts

180. See, e.g., *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 903 (10th Cir. 1992), *rev'd on other grounds*, *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (adopting the view that recklessness satisfies the scienter standard); *Levine v. Diamanthust, Inc.*, 950 F.2d 1478, 1484–85 & nn. 4–5 (9th Cir. 1991) (noting that a third party's reckless disregard of a violator's action suffices for a cause of action for aiding and abetting the violator); *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981) (explaining that reckless disregard suffices for a cause of action for aiding and abetting).

181. See *infra* note 186 (detailing situations in which courts held recklessness sufficient).

182. The SEC's *amicus curiae* brief concluded as follows:

In sum, the scienter standard for aiding and abetting liability under Rule 10b-5 should be neither so low that liability exposure is excessive, nor so high that unlawful activity will escape deterrence and remediation. The recklessness standard avoids both liability for good faith or merely negligent conduct, and the undue weakening of the securities laws that would result from insistence on often elusive proof of conscious intent.

Brief for the Securities and Exchange Commission as Amicus Curiae in Support of Respondents at 29–30, *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (No. 92-854).

183. In some court opinions, there is perhaps an unconscious elision of these two scienter requirements, such that their formulations are treated as fungible. Such a disagreement is evident in a recent case, *Howard v. SEC*, 376 F.2d 1136 (D.C. Cir. 2004), where the concurring opinion explicitly chided the majority for conflating the two different scienter standards. *Id.* at 1150–52 (Henderson, J., concurring). While I will argue that the two formulations need not be substantively different in practice, the respective mental state requirements stem from different underlying statutory policies.

184. In cases involving aiding and abetting by inaction (as opposed to affirmative

held that recklessness sufficed only if the defendant owed a duty to the plaintiff respecting the alleged violation.¹⁸⁵ For example, under this so-called duty theory, a party would be liable for aiding and abetting an issuer's disclosure violation only if the aider and abettor owed investors a duty to disclose. A third group of courts applied a slightly less stringent standard, the so-called sliding scale approach, ranging from recklessness to conscious intent.¹⁸⁶ Under this approach, recklessness was sufficient if the aider and abettor was under an independent duty to disclose. In addition, in the absence of any such duty, recklessness would suffice, but only if the assistance was unusually significant in scope or degree.

The range of views regarding the mental state required for aiding and abetting liability prior to *Central Bank* underscores the challenges of a standards-based approach to complicity. Built into the standards approach is an avowed narrowing of anti-complicity principles. As the mental state standards are ratcheted up, secondary actors have less of an incentive to self-monitor their conduct or proactively engage the primary actor in the face of red flags. In short, conventional culpability-based standards of aiding and abetting tended to give secondary actors wide berth in their dealings with primary violators.

3. Administrative Aiding and Abetting—Same Problem, Different Venue

The relevant administrative standard closely paralleled the development of implied theories of aiding and abetting liability in civil actions prior to *Central Bank*,¹⁸⁷ but the interdependency among the civil

assistance), courts have typically required a higher mental state, exceeding recklessness. The higher mental state is required to determine whether the actor's inaction is an affirmative form of assistance or mere inattentiveness to circumstances.

185. See, e.g., *Schatz v. Rosenberg*, 943 F.2d 485, 496 (4th Cir. 1991) (stating that without a fiduciary duty, the applicable scienter requirement is actual knowledge); *Edwards & Hanley v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979) (citing *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47–48 (2d Cir. 1978)) (noting that recklessness suffices for aider and abettor liability where a fiduciary duty was owed).

186. See, e.g., *Akin v. Q-L Inv., Inc.*, 959 F.2d 521, 531–32 (5th Cir. 1992) (noting that certain circumstances entailing a special independent fiduciary duty may lessen the scienter standard to recklessness); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480–81 (11th Cir. 1988) *cert. denied*, 490 U.S. 1091 (1989) (lessening the scienter standard to recklessness with regards to special independent fiduciary duty); *Metge v. Baehler*, 762 F.2d 621, 624–25 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986), *cert. denied*, 474 U.S. 1072 (1986) (explaining that when some special duty of disclosure exists, liability correspond to a lesser degree of scienter); *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1009–10 (11th Cir. 1985) (applying a recklessness scienter requirement where the assistance deviated significantly from the standards of ordinary care).

187. *Compare Investors Research Corp. v. SEC*, 628 F.2d 168 (D.C. Cir 1980) (stating that awareness of unlawfulness alone might be sufficient to satisfy the scienter requirement),

and administrative law standard is noteworthy. The pre-*Central Bank* judicially-created standard for aiding and abetting fraud (a standard subsequently swept aside by the *Central Bank* decision) was largely imported into the administrative realm to determine how to better formulate statutorily-created aiding and abetting standards. On its face, such an approach was inappropriate to the extent that the civil law formulation was influenced by the fact that the civil law remedy had been implied, rather than statutorily mandated, for the obvious reason that the administrative standard was prescribed by statute rather than implied.¹⁸⁸ Indeed, the administrative standard arguably should have been construed liberally given its administrative law origins.¹⁸⁹ Nevertheless, in the critical case of *Investors Research v. SEC*,¹⁹⁰ the court's analysis of the administrative aiding and abetting standard was heavily influenced by the civil standard applied in private fraud actions without explicitly recognizing the fundamentally different contexts in which the standards were being applied.¹⁹¹ This result was particularly important in understanding the culpability standard applied in administrative proceedings.

In *Investors Research*, the SEC sanctioned a broker for aiding and abetting an investment adviser's violation of the affiliated compensation prohibitions of Section 17(e)(1) of the Investment Company Act.¹⁹² The provision strictly prohibits affiliates of registered investment companies (RICs), such as investment advisers or their employees, from receiving additional compensation from persons other than the RIC in acting as an agent on the RICs behalf. In this case, the investment adviser directed trades on behalf of the RIC to broker-dealers that had other material

with *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1978) (holding that the scienter requirement is predicated upon actual awareness), and *SEC v. Coffey*, 493 F.2d 1304, 1316, 1319 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) (holding scienter requirement as predicated upon awareness in a SEC injunctive action). During the 1970s, a period of rapid expansion in the use of aiding and abetting theories—both in SEC civil and administrative actions as well as private damages actions—the familiar three pronged analysis took shape. The SEC now routinely incorporates this approach into its own decisions. See, e.g., Sharon M. Graham, Exchange Act Release No. 40727 1998 WL 34300386 (Nov. 30, 1998), *aff'd*, *Graham v. SEC*, 222 F.3d 994 (D.C. Cir. 2000). In many cases, courts used civil and administrative standards interchangeably without any apparent recognition that the standards had different legal foundations (one statutory and the other implied) and could at least in theory diverge in some respects.

188. Thus, for example, the Seventh Circuit expressly stated that its civil law standard was intentionally restrictive because based on an implied remedy. See *supra* note 161. That consideration is not relevant in the case of the administrative law standard.

189. Cf. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2304 n.8 (2011) (noting that the normal deference accorded to issues committed to agency's administrative discretion is not applicable in private litigation).

190. 628 F.2d 168 (D.C. Cir. 1980).

191. *Id.* at 178.

192. 15 U.S.C. §80a-18(e) (2006).

commercial relationships with the investment adviser. The court vacated the SEC's finding that the broker had aided and abetted the RICs violation because the SEC had not found that the broker was any more than negligent in failing to recognize the violation. The court concluded that a finding of aiding and abetting claims required a relatively strong form of scienter, even when the primary violation itself had no scienter requirement, to ensure that innocent secondary parties were not unfairly sanctioned for negligence.¹⁹³

Even if the *Investors Research* court was correct as to the broker (a person who was not affiliated with the primary violator), the result seems problematic when applied to affiliated parties of the primary violator, such as employees. Congress had already mandated in many contexts that primary liability may attach to corporate registrants without a showing of fault. It is hard to see how it is unfair to impose liability on the employees who bore primary responsibility for the corporation's violation if fairness considerations do not preclude imposing liability on a corporate entity whose fault is solely traceable to the employee. In such a situation, the liability of both the corporation, the primary actor, and the employee, the secondary actor, arise from precisely the same conduct, namely that of the employee. The D.C. Circuit's approach, which is now firmly entrenched, leads to seeming nonsensical results where, for example, an investment company may be strictly liable for pricing its shares in a way directed by the president of the company, even though the president, who directed the pricing policy, cannot be found liable for the same violation as a secondary actor, absent a showing that he was aware that the conduct was unlawful.¹⁹⁴ The effect of this particular judicial policy is to eliminate liability for complicity for many types of violations entailing strict liability absent a

193. Although the *Investors Research* court rejected negligence as a basis for aiding and abetting liability, it seemed open to finding the requisite culpability from recklessness—an approach adopted by most courts both before and after *Central Bank*. See, e.g., *Monetta Fin. Servs. v. SEC*, 390 F.3d 952, 956–57 (7th Cir. 2004) (explaining the awareness requirement of aider and abettor liability satisfied by recklessness); *Geman v. SEC*, 334 F.3d 1183, 1195–96 (10th Cir. 2003) (finding an aider and abettor liable from a state of mind of recklessness). Although in recent years judicial decisions have not challenged the use of a recklessness standard per se, some courts have challenged the proper formulation of the recklessness standard and the circumstances that support such a finding. See, e.g., *SEC v. Howard*, 376 F.3d 1136, 1150 (D.C. Cir. 2004) (finding that the SEC had erroneously treated recklessness as a “should have known” standard without reference to awareness). *Howard* technically did not implicate an express aiding and abetting provision under the federal securities law, but rather a power to issue cease-and-desist orders against persons causing violations pursuant to Section 21C of the Exchange Act, 15 U.S.C. § 78u-3 (2006). Aiding and abetting is encompassed by the broader concept of causing violations and the court of appeals specifically treated it as an aiding and abetting case because that was the theory advanced by the SEC in the administrative proceeding.

194. *SEC v. Steadman*, 967 F.2d 636, 647–48 (D.C. Cir. 1992).

showing of scienter.

C. Complicity Standards Post-Central Bank and the Dodd-Frank Palliative

Following *Central Bank*, Congress has engaged in efforts to reform the standards-based anti-complicity policy. As discussed below, although the legislative initiatives enacted have provided modest improvements, they fall far short of the robust anti-complicity initiative recommended in this article.

Although Congress did not restore the implied private cause of action for aiding and abetting after *Central Bank*,¹⁹⁵ it effectively repudiated *Central Bank*'s insinuation that the SEC lacked the power to bring civil aiding and abetting actions. As part of the PSLRA, Congress expressly codified the SEC's authority to bring civil enforcement actions against persons who "knowingly provide substantial assistance" to primary violators.¹⁹⁶ In this way, Congress restored the ability of the SEC to seek civil sanctions for aiding and abetting securities law violations. The congressional reaction to *Central Bank* is at least noteworthy as yet another example of the well-established legislative policy favoring standards to police complicity.¹⁹⁷

195. As to Section 20(e) of the Exchange Act, the Senate Report is instructive. The original House bill contained no such provision and the Conference Report accompanying the PSLRA as enacted did not elaborate on Section 20(e). H.R. REP. NO. 104-369, at 37 (1995) (presenting the Joint Explanatory Statement of the Committee of Conference). See also H.R. 1058, 104th Cong. (1st Sess. 1995) (providing an example of proposed legislation failing to elaborate on Section 20(e)). The language in the Senate Report explained the Committee's decision to *not* restore actions for private damages because of the perceived potential to engender litigation abuses. See S. REP. NO. 104-98, at 19–20 (1995) (accompanying the Senate bill, S. 240, 104th Cong. (1st Sess. 1995), which was the legislative source of the final provision). Senator Bryan attempted to amend the Senate bill to restore aiding and abetting liability in private damage actions, but his attempt failed. 141 CONG. REC. S9032 (daily ed. June 26, 1995) (statement of Sen. Bryan) (Amendment No. 1474); 141 CONG. REC. 9073, 9109–12 (1995).

196. PSLRA, *supra* note 7 (codified at 15 U.S.C. § 78(t)(e) (2006) and subsequently amended 15 U.S.C. § 78(t)(e) (Supp. IV 2010)).

197. Even apart from disagreements regarding the proper formulation of the aiding and abetting standard discussed below, there was also a parallel recognition that aiding and abetting standards alone would not always be effective in inducing the desired secondary actor behavior. This realization was particularly pronounced in the case of attorneys. In the wake of Enron, there was widespread criticism of the seeming lack of accountability on the part of lawyers for their role in clients' misconduct. See generally Susan P. Koniak, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 COLUM. L. REV. 1280 (2002) (criticizing attorneys for indirectly aiding the securities law misconduct of clients). Congress shared this sentiment, which led to the enactment of Section 307 of the Sarbanes-Oxley Act of 2002. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. § 7245 (2006)) (authorizing the SEC to establish professional standards for securities

The statutory restoration of the SEC's civil enforcement authority to bring actions against aiders and abettors, however, also illustrates the inherent problem of interpretation triggered by standards. The statutory language in Exchange Act Section 20(e) differs from the statutory language that serves as the basis for administrative proceedings directed at aiding and abetting; the SEC, as originally codified, could proceed civilly against persons who "knowingly provide substantial assistance"¹⁹⁸ to primary violators as aiders and abettors, while it may sanction securities professionals administratively that "willfully aid and abet."¹⁹⁹ Not surprisingly, this discrepancy immediately resulted in conflicting judicial interpretations regarding whether the "knowingly" formulation encompassed recklessness,²⁰⁰ even though recklessness was sufficient to satisfy the requisite mental state in administrative aiding and abetting actions.²⁰¹ The problem was ultimately resolved in the Dodd-Frank Act, which contained a provision amending Exchange Act Section 20(e) by statutorily permitting liability as to persons who "knowingly or recklessly provide substantial assistance."²⁰²

The recently enacted Dodd-Frank Act made three important changes to the prevailing standards-based anti-complicity regime. As noted, the Act explicitly clarified the culpability standard in SEC civil enforcement of

attorneys); *see also* 148 CONG. REC. S.6551-52 (statement of Sen. Edwards), S.6554-53 (statement of Senator Enzi), S.6556 (statement of Sen. Corzine) (daily ed. July 10, 2002) (expressing concerns regarding role of lawyers in securities scandals in the wake of Enron). For a discussion of the overlapping state and federal law obligations of attorneys following the Sarbanes-Oxley Act and SEC rulemaking, *see* Giovanni P. Prezioso, General Counsel, U.S. Securities and Exchange Commission, *Remarks before the American Bar Association Section of Business Law 2004 Spring Meeting* (April 3, 2004) (noting that a number of issues have triggered debate relating to the role of lawyers in avoiding complicity with client misconduct under the securities laws); *see also supra* notes 86, 141.

198. 15 U.S.C. § 78t(e) (2006).

199. 15 U.S.C. § 78(o)(b)(4)(E) (2006) (regarding associated persons of broker-dealers); 15 U.S.C. § 80b-3(e)(6) (2006) (regarding associated persons of investment advisers).

200. *See* David S. Slovick, *Scienter and Section 20(e): A New Consensus on Aiding and Abetting Liability in SEC Enforcement Actions*, 36 SEC. REG. L. J. 317, 324 (2008) (suggesting an emerging consensus for actual knowledge prior to passage of the Dodd-Frank Act). *Compare* SEC v. KPMG LLP, 412 F. Supp. 2d 349, 382-83 (S.D.N.Y. 2006) (explaining that "the fact that the 'knowingly' was defined as actual knowledge in the very same bill that contained Section 20(e) weighs in favor of the . . . contention that the provision does not encompass recklessness"), *with* SEC v. Peretz, 317 F. Supp. 2d 58, 64 (D. Mass. 2004) (holding that "[w]here the defendant has a duty to disclose the primary violations, . . . courts have been willing to impose liability on the basis of a recklessness standard") (quoting *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983)).

201. *See, e.g.,* *Graham v. SEC*, 22 F.3d 994, 994 (D.C. Cir. 2000) (sanctioning a brokerage firm owner for fraudulent trades, and holding that "elements for aiding and abetting liability were established" through using a recklessness standard).

202. Dodd-Frank Act, *supra* note 8, § 929O, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78(t)(e) (Supp. IV 2010)). .

aiding and abetting actions.²⁰³ The existing “knowing” assistance standard, which had sparked judicial conflict in its application, was expressly broadened to encompass recklessness.²⁰⁴ Secondly, it allowed penalties to be imposed administratively for causing violations in C&D proceedings.²⁰⁵ Finally, the Act established a uniform aiding and abetting enforcement framework across all securities statutes (the Investment Advisers Act,²⁰⁶ the Securities Act,²⁰⁷ the Investment Company Act,²⁰⁸ in addition to the Exchange Act²⁰⁹).²¹⁰ Congress separately considered the issue of allowing private civil suits against securities violators, but ultimately failed to include such provisions in the Dodd-Frank Act.²¹¹

203. *Id.*

204. *Id.* See generally Slovic, *supra* note 200 (discussing the conflicted history of the knowledge standard for aiding and abetting liability under the securities laws).

205. Dodd-Frank Act, *supra* note 8 § 929P(a). This expansion of authority permits the SEC to seek civil monetary penalties in cease-and-desist proceedings if the Commission determines, after notice and opportunity for hearing, a person violated or caused a violation of the securities laws. *Id.*

206. *Id.* § 929N (adding new section 209(f) to the Advisers Act (codified at 15 U.S.C. §80b-9(f) (Supp. IV 2010)). The amendment provides authority for the SEC to seek monetary damages in a civil action against a person who aids or abets in a violation of the Advisers Act. *Id.* Prior to Dodd-Frank, the Advisers Act limited the SEC to seeking injunctive relief against aiders and abettors. Investment Advisers Act of 1940 § 209(d) (codified at 15 U.S.C. §80b-9 (2006)). It is important to note that new section 209(d) does not explicitly require “substantial assistance” as does the Exchange Act, relying instead on the traditional aid and abet formulation. Compare 15 U.S.C. §80b-9 (2006) with 15 U.S.C. § 78(t)(e) (Supp. IV 2010)).

207. Dodd-Frank Act, *supra* note 8, § 929M(a) (adding new section 15(b) to the Securities Act of 1933 codified at 15 U.S.C. §77o(b) (Supp. IV 2010)). The amendment provides authority to seek penalties against those who “knowingly or recklessly provide substantial assistance to another” in violation of the Act. *Id.* The 1933 Act previously did not provide authority to penalize aiders and abettors.

208. Dodd-Frank Act, *supra* note 8, § 929M(b) (adding new section 47 to Investment Company Act of 1940 codified at 15 U.S.C. §80a-47(b) (Supp. IV 2010)). The amendment brings the authority to penalize aiders and abettors under the Investment Company Act into conformity with the Exchange Act and the amended Securities Act where such authority did not previously exist. *Id.*

209. See *supra* notes 202–04.

210. Dodd-Frank Act, *supra* note 8, § 929P (simultaneously amending the Securities Act, Investment Company Act, Exchange Act and Advisers Act to enable the SEC to seek civil penalties in C&D proceedings).

211. See Elizabeth Skola, *Aiding and Abetting Liability Provision Omitted from Financial Reform Bill*, ALSTON BIRD SECURITIES LITIGATION BLOG (July 9, 2010, 3:58 PM), <http://securities.litigation.alston.com/blog.aspx?entry=3738> (discussing the background of bills proposing private rights of action against aiders and abettors and also noting that compromise among conferees in House and Senate led to inclusion of study and ultimate rejection of private action provisions in Dodd-Frank). In the United States House of Representatives and the Senate, respectively, Congresswoman Maxine Waters and Senator Arlen Specter introduced similar bills that would expressly allow for a private right of action against any person who provided substantial assistance in any violation of the Exchange Act. Liability for Aiding and Abetting Securities Violations Act of 2009, S. 1551, 111th

These changes undoubtedly will be beneficial in shoring up the effectiveness of anti-complicity standards. The SEC will have greater flexibility in proceeding against complicit parties both civilly and administratively. The inherent structural complexity of the standards regime, however, remains. More importantly, the revisions to the standards-based regime do not address its inherent deficiencies. As discussed above, the manner in which standards are formulated is largely anchored in notions of personal culpability and accountability that do not address forms of complicity in which either the secondary participant does not recognize that he or she is assisting in the unlawful behavior of another or facilitates primary violations through inaction.

D. In the Shadow of Central Bank

The foregoing subsections show that anti-complicity standards entail a significant degree of uncertainty and address an incomplete range of complicit conduct. What is the significance of the Supreme Court's decisions in *Central Bank* and subsequently in *Stoneridge* and *Janus Capital* (collectively, I refer to the three decisions as the *Central Bank* trilogy) in thinking about anti-complicity policy? The answer surprisingly is: not much and, to the extent they are relevant, they are surely problematic. Indeed, the most problematic aspect of the *Central Bank* trilogy is not the much criticized holdings foreclosing liability for damages (though such criticism surely has some merit²¹²), but rather the Court's inability to articulate a principled distinction between primary and secondary liability (or even to recognize the possible relevance of anti-complicity policies to the remedial purposes of the federal securities laws).

Ironically, the *Central Bank* decision was supposed to have provided definitive guidance regarding the contours of liability for aiding and abetting violations under federal securities law. As noted above, although a consensus existed among the federal courts of appeals recognizing aiding and abetting liability in private damages actions,²¹³ the courts articulated a

Cong. (1st Sess. 2009); Liability for Aiding and Abetting Securities Violations Act of 2010, H.R. 5042, 111th Cong. (2d. Sess. 2010). While these damages provisions were omitted from the Dodd-Frank Act, the Act did provide for a study analyzing the "impact of authorizing a private right of action against any person who aids and abets another person in violation of the securities laws." Dodd-Frank Act, *supra* note 8, § 929Z.

212. On policy grounds, this article offers some justification for eliminating private damages action by arguing that a more robust anti-complicity regime could be effectuated through an expansive rules-based strategy. Indeed, the article notes the potential tension, to some extent, between an approach that relies on damages for all forms of complicity and a more expansive anti-complicity regime. Concerns regarding excessive damages only serve to encourage narrowly-crafted anti-complicity standards. See discussion *infra* Section IV.

213. See *supra* note 122 and accompanying text.

variety of different substantive approaches.²¹⁴ The Supreme Court's response in *Central Bank* offered no guidance in that respect.²¹⁵ Congress had not expressly created a private right of action for secondary liability under Section 10(b). The Court concluded that, absent legislative action, one could not be implied based on its perception of an equivocal statutory record that would support such an implication.²¹⁶ In effect, the Court's decision rendered moot any discussion of the substance of such liability standards.²¹⁷

Had the Court merely concluded that it was not appropriate to imply a private right of action and no more, the decision's consequences would have been more limited (though still dramatic in terms of limiting private actions). But the decision's reasoning went beyond this limited result, thereby setting the stage for subsequent analytical problems. In the Court's view, "§ 10(b) [did] not prohibit aiding and abetting."²¹⁸ The majority's view could actually be restated in a way that is more relevant to this article: the expansive rulemaking authority under Section 10(b) conferred on the SEC does not extend to promulgating rules that would prohibit complicity in fraud. The Court's reasoning left little doubt that the SEC lacked authority to bring civil enforcement actions against persons complicit in securities fraud (or any other securities law violation).²¹⁹ Congress quickly and decisively overruled that implication.²²⁰

214. See *supra* note 146 and accompanying text.

215. See also *Central Bank v. First Interstate Bank*, 508 U.S. 959 (1993) (mem.) (granting petition for writ of certiorari and raising issue of existence of private cause of action *sua sponte*).

216. *Central Bank*, *supra* note 1, at 178.

217. *Id.* at 177–78.

218. *Id.* at 199.

219. Justice Stevens's dissenting opinion expressly averted to this implication. *Id.* at 200. This conclusion became the prevailing wisdom among commentators. See, e.g., Ruder, *supra* note 147, at 1486 (1994) (suggesting negative implications of the Supreme Court *Central Bank* decision on the interpretation of rule 10b-5); Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1430, 1434–35 & n.36 (1994) (discussing the *Central Bank* decision and its detrimental effects on aiding and abetting claims). In an entertaining exchange, two pieces envisioned draft Supreme Court opinions resolving the issue. Edward C. Brewer III & John L. Latham, *SEC v. Central Bank: A Draft Opinion for the Court's Conference*, 50 BUS. LAW. 19 (1994) (discussing a draft opinion extending *Central Bank* to SEC civil aiding and abetting actions); Simon M. Lorne, *Central Bank of Denver v. SEC*, 49 BUS. LAW. 1467 (1994) (incorporating draft opinion by the SEC's then-General Counsel holding that *Central Bank* did not preclude SEC civil actions for aiding and abetting).

220. PSLRA, *supra* note 7 (codified at 15 U.S.C. §78t(e) (2006) and subsequently amended (Supp IV 2010)) (providing that the SEC may bring civil actions against "any person that knowingly provides substantial assistance to another person in violation of a provision of [the securities laws], or of any rule or regulation issued" thereunder). An attempt to amend the PSLRA by restoring private rights of action—the so-called Bryan Amendment—failed in the Senate and died, though this issue returned in connection with

The Court's one-sided discussion of the policy implications of aiding and abetting liability is noteworthy for its crabbed view of the importance of anti-complicity policies. The majority opinion gives short shrift to any perceived anti-complicity benefits from the statute's long-recognized remedial purposes (especially arising from SEC enforcement actions), tersely acknowledging that "extending the 10b-5 cause of action to aiders and abettors no doubt makes the civil remedy more far-reaching"²²¹ It mistakenly insinuated that Congress plausibly could have intended to foreclose secondary liability because its grant of rulemaking authority did not expressly enumerate such an objective,²²² and that recognition of secondary liability might potentially conflict with the statute's objectives.²²³ As explained in the preceding subsection, Congress has consistently acted to expand liability for complicity in law enforcement actions under federal securities law.²²⁴

Undoubtedly, countervailing concerns regarding excessive private litigation might offer some justification for not implying a private right of action, but the Court framed its holding in terms that encompassed both governmentally and privately enforced anti-complicity principles, rather than the narrower issue of an implied cause of action for private damages.²²⁵ Indeed, the failure to acknowledge potential differences in law enforcement actions and private damage actions²²⁶ makes the Court's discussion of Congress's broad recognition of criminal liability for aiding and abetting sound disingenuous. Congress's broad recognition of criminal aiding and abetting for securities law violations has a meaningful analogue in SEC law enforcement actions, an area directly implicated by the Court's own reasoning, but the majority instead stressed the less germane inapplicability of criminal law policy in designing private litigation remedies.²²⁷

The most problematic aspect of the Court's reasoning, and its most enduring effect, however, has been its restrictive construction of language

the Dodd-Frank Act. *See supra* Section II.B.2.

221. *Central Bank*, *supra* note 1, at 188.

222. *Id.* at 179–80.

223. *Id.* at 188 ("Extending the 10b-5 cause of action to aiders and abettors no doubt makes the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served.").

224. *See supra* Section II.A. Indeed, as the majority itself acknowledged, the extant legislative materials seemed to support congressional acquiescence. *Central Bank*, 511 U.S. at 185–87.

225. There is some irony in the Court's observation that the "rules for determining aiding and abetting liability are unclear" as a policy factor weighing against aiding and abetting standards in view of the fact that the very purpose for granting certiorari was supposed to have caused the Court to resolve uncertainty in the area. *Id.* at 188.

226. *Id.* at 190.

227. *Id.*

that seemed to suggest that a broad range of secondary actors might be subject to liability, provided that they “[made] a material misstatement (or omission) on which a purchaser or seller of securities relies . . . assuming all of the requirements for primary liability under Rule 10b-5 are met.”²²⁸ The critical distinction between primary and secondary liability under the Court’s approach turned on who made the material misstatement.²²⁹

Although *Central Bank* held out the possibility that many types of secondary actors might be liable under the “making” standard, this outcome has proven largely illusory as both the *Stoneridge* and *Janus Capital* cases demonstrate. The two subsequent decisions each confronted the issue of who could be sued as a primary violator in connection with fraudulent disclosure. In resolving this issue, the Court eschewed reliance on the relatively common sense approach of affixing primary liability in terms of relative responsibility among participants, instead relying upon a mechanical test for determining who “made” the alleged misrepresentation to investors.

In *Stoneridge*, the Court analyzed the liability of two companies that supplied equipment to a public company whose financial statements contained material misrepresentations.²³⁰ The equipment suppliers entered into transactions with the public company that disguised the true nature of the suppliers’ transactions with the public company.²³¹ As a result, the public company was able to create misleading financial statements without

228. *Id.* Justice Kennedy reinforced this point with his observation that recognition of actions for aiding and abetting generally would potentially undermine the well-established element of reliance in private Rule 10b-5 actions because defrauded investors rely, explicitly or implicitly, on the primary violators’ conduct rather than the unknown assistance of a secondary party. *Id.* at 180.

229. As the Court subsequently explained in *Janus Capital*: “[F]or *Central Bank* to have any meaning, there must be some distinction between those who are primarily liable (and thus may be pursued in private suits) and those who are secondarily liable (and thus may not be pursued in private suits).” *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 n.6 (2011). Because private litigants could no longer seek damage remedies against aiders and abettors in light of this, plaintiffs have to meet the challenge of *Central Bank* by expanding the scope of primary liability under Rule 10b-5 while defendants predictably have sought to narrow primary liability. This led to a split in the circuits regarding the appropriate test for primary liability and generated conflicting commentary. *See, e.g.,* Aegis J. Frumento, *Misrepresentations of Secondary Actors in the Sale of Securities: Does In re Enron Square with Central Bank?*, 59 BUS. LAW. 976 (2004) (examining the need to explore further the concept of secondary actors post-*Central Bank* as a result of the case); Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293 (1999) (arguing against the Court’s literal textualism approach in *Central Bank*). As discussed below, the Supreme Court’s recent holding in *Janus Capital* adopted the restrictive view of primary liability.

230. *See supra* note 2 and accompanying text.

231. *Id.* at 154–55.

its outside auditor catching on to the misstatements.²³² Under any theory of the case, the two secondary parties were complicit in the misrepresentations and, at a minimum, aided and abetted the public company's fraudulent statements.²³³ Because the matter arose in a private action, however, the only viable securities fraud claim that could be asserted against the equipment suppliers was for primary liability.²³⁴ The plaintiffs alleged that the equipment suppliers were primarily liable as participants in a "scheme" to defraud because the two secondary actors themselves had specifically engaged in fraudulent conduct—i.e., following *Central Bank*, had actually "made" and subscribed to false statements in documenting the transactions.²³⁵

A closely divided Court rejected the claim in reasoning that was ultimately more problematic than the result (though, once again, there is something obviously unappealing about a holding that allows highly culpable parties to escape liability). While the holding necessarily evidences a restrictive view of Rule 10b-5, it is defensible at an intuitive level (assuming that *Central Bank* was correct) as drawing the line between conduct that constitutes the violation and conduct that is properly viewed as aiding and abetting the violation. The Court reasonably could assert that the line between primary and secondary liability should be drawn in this case between the secondary actors and the primary actor because the actors were not equally responsible for the scheme and the suppliers had merely assisted the public company's violations in connection with the scheme.²³⁶ In other words, the Court could have concluded that the suppliers' conduct—though part of a fraudulent scheme—was secondary in nature to the fraud perpetrated by the public company.²³⁷

However, according to the Court's much-criticized reasoning in *Stoneridge*,²³⁸ the plaintiffs' cause of action as to the secondary parties was

232. *Id.* at 154 & 161.

233. *Id.* at 162–63.

234. The perception that injured investors were in effect circumventing *Central Bank*'s prohibition on damages for secondary liability was very much at the fore of the majority's resistance to petitioner's theory. See *Id.* at 162–63 ("Were we to adopt this construction of §10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating fraud.").

235. *Id.* at 159–60.

236. For a similar recognition of this deficiency in *Stoneridge* but with a different framework for resolving the issue, see Ronald J. Colombo, *Cooperation with Securities Fraud*, 61 ALA. L. REV. 61, 89 (2009) (noting that *Stoneridge* "provide[s] little guidance to courts and counsel struggling with the distinction between primary and merely secondary liability under § 10(b)" and suggesting a resolving framework based a cooperation analysis drawn from moral philosophy).

237. *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 161 (2008).

238. See, e.g., Mark Klock, *What Will It Take to Label Participation in a Deceptive Scheme to Defraud Buyers of Securities a Violation of Section 10(b)? The Disastrous Result*

fatally flawed because they could not “show reliance upon any of the [defendant secondary actors’] actions except in an indirect chain that we find too remote for liability.”²³⁹ This formulation of the holding is highly problematic because it suddenly ties the violation to investors’ perception of the misconduct, rather than the misconduct itself. There is a difference between the less objectionable assertion that the only actionable securities fraud consisted of the misrepresentations contained in the financial statements issued by the public company and the untethered assertion that the secondary parties could not commit fraud because investors did not realize the role of the secondary parties in the fraudulent scheme, no matter how significant the secondary parties’ actual role in the fraud. The former assertion is merely drawing a line between securities fraud and assisting (or complicity in) the fraud. The latter assertion—that a person cannot commit securities fraud unless known to the injured party—is counterfactual in two respects. First, persons can perpetrate a fraud on victims who are ignorant of the fraudster or the fraudster’s role in the fraud. Indeed, that is the essence of fraud based on silence in market transactions such as insider trading. Second, as the dissent makes clear, the fraud on the market theory is predicated on the assumption that persons are frequently injured even where they had no personal knowledge of the misrepresentation, let alone the party making the misrepresentation.²⁴⁰

The perversity of *Stoneridge* becomes evident in the most recent decision of the *Central Bank* trilogy, *Janus Capital*.²⁴¹ The asset manager, Janus Capital, and its subsidiary asset manager, were sued by Janus Capital shareholders for misrepresentations made by the asset manager in preparing

and Reasoning of *Stoneridge*, 58 U. KAN. L. REV. 309 (2010) (criticizing *Stoneridge* for both the Court’s reasoning and the actual result); Franklin A. Gevurtz, *Law Upside Down: A Critical Essay on Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 103 NW. U. L. REV. COLLOQUY 448, 449 (2009) (suggesting that the case “illustrates how utterly irrational the law governing private securities fraud actions has become”); Robert A. Prentice, *Scheme Liability: Does It Have a Future After Stoneridge?* 2009 WIS. L. REV. 351, 352–53 (2009) (exploring the implications of *Stoneridge* on scheme liability, and arguing for a broad interpretation of the case); Robert A. Prentice, *Stoneridge, Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611, 611–12 (2008) (suggesting that in *Stoneridge*, “the Court committed an anachronistic error comparable to a cowboy movie showing John Wayne listening to an iPod as he rides his horse across the Old West”). For a critical, yet sympathetic reinterpretation of *Stoneridge*, see Donald C. Langevoort, *Reading Stoneridge Carefully: A Duty-Based Approach to Reliance and Third-Party Liability under Rule 10b-5*, 158 U. PA. L. REV. 2125, 2138–48 (2010) (examining the *Stoneridge* decision, inquiring into the concepts of remoteness and disproportion, and suggesting ways to interpret the decision in more favorable light). In light of the Supreme Court’s *Janus Capital* decision, it is clear that the Supreme Court declined to follow Professor Langevoort’s more palatable interpretive approach.

239. *Stoneridge*, 552 U.S. at 159.

240. *Id.* at 170–71 (Breyer, J., dissenting).

241. *See supra* note 4.

disclosure for mutual funds managed by Janus.²⁴² The facts relating to the plaintiff class involved a slight twist. While undoubtedly the mutual fund shareholders were deceived by the false disclosure, this action was brought by Janus Capital's shareholders on the theory that they were also allegedly injured by the false mutual fund disclosure issued by the Janus Funds.²⁴³ In *Janus Capital*, unlike *Stoneridge*, the offending disclosure that allegedly deceived Janus Capital's shareholders had been prepared by Janus's asset manager for Janus-advised funds and the asset manager appeared to have exclusive knowledge of the true facts which made the disclosure misleading. In this situation, only the asset manager personnel had the requisite fraudulent intent.²⁴⁴

The Court held that the asset manager could not be primarily liable for securities fraud in these circumstances. The problem from the Court's perspective was that the disclosure itself was never directly attributed to Janus Capital nor to the asset manager, but rather to the Janus Funds that nominally had issued the misleading disclosure. The Court crafted a new "ultimate authority" test for primary liability under which only the maker of the false statement can be primarily liable, and "[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."²⁴⁵ The Court's holding, read literally, turns complicity on its head. The line between primary liability and secondary liability has little to do with whether conduct is regarded as the source of the fraud or merely assistance. Instead, it turns on an entirely formalistic distinction of the actor's ultimate authority (in the legal sense) to make the statement. Thus, according to the majority, merely drafting a false disclosure with knowledge of its falsity and subsequently deceiving another into believing that the statement is accurate, does not alone make an individual primarily liable for fraud, so long as the other person disseminates the statement in its own name. In trying to distinguish primary liability and aiding and abetting, the Court has actually crafted a rule insulating from liability those who in fact may be primarily responsible.

The ultimate significance of the *Central Bank* trilogy in thinking about complicity is in illustrating how deficient the judicial standards scheme has become. Not only did *Central Bank* not shed any light on the substance of

242. *Id.* at 2300-01.

243. Because this action was addressed at the pleading stage, it is unclear whether plaintiffs would have been able to demonstrate loss causation arising from false disclosure in Janus Funds' disclosure on Janus Capital's share price.

244. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2297-98 (2011).

245. *Id.* at 2302. Justice Breyer's dissent branded this test as lacking support in "common" usage or "earlier cases." *Id.* at 2306.

aiding and abetting standards but, ironically, it became the vehicle for artificially limiting the scope of primary liability. An indirect and unhappy consequence of this approach may be that just as the floor on primary liability has been judicially raised, so too will the floor on complicity. This is directly contrary to the reform proposal advanced here, which seeks to expand the reach of anti-complicity policies so as to discourage a broad range of different forms of assistance. Given the Supreme Court's failure to rationalize the law in this area, perhaps the best that can be done is to take the Court's advice and seek a fix from non-judicial policy makers.²⁴⁶

IV. A PRAGMATIC ASSESSMENT OF THE PROBLEM WITH STANDARDS

In this section, considerations from preceding sections are marshaled to argue that exclusive reliance on a standards-based regime is unwise from a policy perspective. The apparent lack of efficacy of the current standards-based regime may stem from the fact that aiding and abetting standards evolved in part from criminal law²⁴⁷ and are grounded in notions of moral culpability (or blameworthiness) and fair notice, so that third parties are not unwittingly subjected to sanction. In the criminal context, notice derives from knowledge or from facts that are sufficiently notorious as to put third parties on notice of the potential for the primary violator's misconduct. Primary reliance on standards in the criminal context seems appropriate to bring about an alignment of criminal sanctions with moral culpability. But if, as is the case in many regulatory contexts, there is no need to align regulatory policy with notions of moral culpability, instrumental considerations may well argue for a rules-based regime over a standards-based regime.²⁴⁸

Certainty and predictability are instrumental considerations that may

246. *Id.* at 2304.

247. *See* Feldman, *supra* note 149 (suggesting that early decisions allowing implied private rights of action against such parties relied, in part, on criminal law precedent).

248. This article asserts (rather than providing an independent justification for the justification) that civil and criminal complicity should be viewed differently. There is, of course, a deep and extensive literature that goes beyond the scope of this paper regarding culpability. Indeed, the idea that there is a fundamental difference in the two different contexts when it comes to culpability and liability has received prominent attention from criminal law scholars. *Compare* Michael S. Moore, *Prima Facie Moral Culpability*, 76 B.U. L. REV. 319 (1996) (defending different concepts of culpability in two different contexts), *with* Claire Finkelstein, *The Irrelevance of the Intended Prima Facie Culpability: Comment on Moore*, 76 B.U. L. REV. 335 (1996) (distinguishing the two contexts as between culpability and accountability in the absence of culpability). Even in the criminal law context, policy arguments have been made against exclusive reliance on intentional culpability standards as an element of criminal complicity in all contexts. *See* Sanford H. Kadish, *Reckless Complicity* 87 J. CRIM. L. & CRIMINOLOGY 369 (1997) (scrutinizing the requirement of intent in criminal complicity statutes).

outweigh the importance of moral blameworthiness in seeking to deter complicity in securities law violations. A standards-based approach that relies heavily on a moral culpability component necessarily forestalls anti-complicity strategies that impose proactive duties on secondary actors in dealing with potential securities law violators.²⁴⁹ Making secondary actors proactive agents for anti-complicity strategies may provide more efficient deterrence in some contexts than trying to identify morally culpable secondary actors after the fact. Instrumental considerations, of course, could favor a standards-based regime. Standards grounded in moral culpability and fair notice may be desirable as an instrumental matter in contexts where regulators are unable to formulate rules that identify, with sufficient precision, sanctionable conduct by secondary actors. The ultimate policy determination regarding type of regime, however, should be based on instrumental considerations of effectiveness and efficiency, rather than an assumption that the locus of liability should be based on notions of moral culpability.

The fundamental problem with standards in the securities law context is their inherent imprecision when clearer guidance to secondary parties might be more effective in bringing about compliance with the law. As discussed in the previous sections, standards designed to limit complicity in the securities law context give rise to complexity in two respects. First, as legal principles, the standards are open-ended and vague and therefore difficult to apply in a predictable and consistent fashion. Frequently, complicity involves passive rather than active assistance and typically involves high culpability thresholds. As a result, findings of liability are highly fact-specific and diminish the odds of making a finding of liability on such grounds.

Standards have also proved complex to administer in practice. The current system of sanctioning complicit secondary actors has, after *Central Bank*, been entrusted almost exclusively to the SEC²⁵⁰ and is built around

249. Cf. Assaf Hamdani, *Mens Rea and the Cost of Ignorance*, 93 VA. L. REV. 415, 415 (2007) (arguing, in the criminal law context, strict liability offenses “induce genuinely ignorant offenders to acquire information” where the offender would otherwise prefer to remain ignorant and avoid criminal sanction).

250. Exceptions to the SEC’s largely exclusive role in the private litigation realm include manipulation under Section 9 of the Exchange Act, false filings with the SEC pursuant to Section 18 of the Exchange Act, and Section 11 of the Securities Act. The principal law enforcement exception to the SEC’s exclusive role is criminal prosecutions for aiding and abetting by the Department of Justice. The crime of aiding and abetting exists under the U.S. Criminal Code rather than the securities laws per se. 18 U.S.C. § 2. While criminal aiding and abetting of securities law violations are brought, *see, e.g.*, *United States v. Faulkenberry*, 614 F.3d 573, 583–84 (6th Cir. 2010) (sustaining CEO’s securities fraud conviction on grounds that his conduct at least satisfied elements of criminal aiding and abetting), such actions are far less frequent than SEC enforcement and administrative proceedings. Although it is difficult to draw generalizations, courts have from time to time

numerous legal gradations encompassing a broad range of potentially complicit behavior. As discussed in Section II.A., this panoply of overlapping standards may convey the sense that there is a robust web of tools at regulators' disposal to police the complicity of secondary actors. For example, the standards governing aiding and abetting civil and administrative proceedings are very high, while those applied in C&D proceedings and in proceedings relating to professional practice are far more flexible.

Nevertheless, the overlapping standards are also a source of problems. Like all standards, the fuzziness that inheres in each variant detracts from the deterrent effect of the relevant standards. The resulting fact-bound collection of orders (based on settlements) is not well-designed to provide prospective guidance to other secondary actors. While the availability of lesser sanctions under slightly watered-down standards may expedite disposition of SEC investigations, it may also lead to the impression that defendants have bargaining opportunities to blunt the imposition of sanctions. Numerous C&D orders are settled with reporting companies, yet no individual employees are named as complicit parties.²⁵¹ Aiding and abetting sanctions themselves may be underused and the lesser sanction of a C&D order (or professional bar) may be overused as a substitute for aiding and abetting sanctions.

The complexity and nuanced nature of the determinations supporting findings of complicity undermine their effectiveness in deterring complicity. In order to be effective, the scheme must put potential offenders on notice of what is required of them and be sufficiently

evidenced some hostility to criminal prosecutions involving fraud in financial reporting. In a recent opinion, Chief Judge Kozinski severely criticized government prosecution of the chief financial officer of Network Associates in connection with the company's use of specific accounting methods in preparing its financial statements that allegedly inflated revenues (though, as the court found, the government had failed to prove beyond a reasonable doubt that the resulting misstatements were material). His concurring opinion states:

This is just one of a string of recent cases in which courts have found that federal prosecutors overreached by trying to stretch criminal law beyond its proper bounds. . . . This is not the way criminal law is supposed to work. Civil law often covers conduct that falls in a gray area of arguable legality. But criminal law should clearly separate conduct that is criminal from conduct that is legal.

United States v. Goyal, 629 F.3d 912, 922 (9th Cir. 2010) (Kozinski, C.J., concurring) (citations omitted).

251. See *supra* note 93 and accompanying text. The Delphi matter in Section I shows similar ad hoc (or possibly highly nuanced) resolutions in which third parties are not sanctioned even though the outside firm (such as the bank and the IT company) appeared to have provided assistance in accounting frauds with high awareness of the underlying circumstances.

predictable so secondary parties are able to conform their conduct to the desired standard. The current system rests heavily on prosecutorial judgment and largely accidental features found in evidentiary records. As noted in Section II.B., the recklessness standard for aiding and abetting is notoriously difficult to apply in a consistent fashion and is particularly difficult to apply in specific instances involving acts of omission rather than acts of commission.²⁵² Moreover, it is difficult to apply to situations involving failure to adhere to affirmative regulatory commands where the party subject to sanction claims ignorance of the regulatory directive.²⁵³ Finally, recklessness alone is not sufficient to establish liability for aiding and abetting. It also requires substantial assistance, an element that has been a subject of inconsistent judicial application.²⁵⁴ The term “causing” in C&D proceedings is potentially broad and has been construed to establish negligence as the appropriate culpability standard (at least in non-scienter primary offenses), but “causing” is extremely amorphous and its bounds have not been rigorously explored in judicial settings.²⁵⁵ Lack of consistency regarding the application of particular elements undermines the utility of these anti-complicity standards in providing clear prospective guidance to secondary actors regarding activities potentially subject to sanction.

Policy preferences for standards or rules may hinge in part on behavioral assumptions regarding the motivations of secondary parties to be complicit. One possibility is that complicit participants are motivated

252. See *supra* Section II.A.1.

253. While doctrine generally has rejected ignorance of the law as a defense, some courts have suggested ignorance may preclude a finding of the requisite mental culpability required of aiders and abettors. See *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952 (7th Cir. 2004) (vacating a finding of aiding and abetting liability because the SEC could not show that the broker was aware that disclosure of IPO allocations was required); *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004) (requiring recklessness for aiding and abetting but not holding the broker liable because the SEC could, at best, show that he had been negligent for not knowing the law and failing to comply). Such a rule severely limits the ability of securities regulators to bring aiding and abetting actions (and hence to seek sanctions) against employees of broker-dealers and investment advisers where the statute or rule imposes affirmative obligations on firms rather than employees of the firms. For commentary critical of these decisions, see Alexander P. Robbins, Comment, *After Howard and Monetta: Is Ignorance of the Law a Defense to Administrative Liability for Aiding and Abetting Violations of the Federal Securities Law?*, 74 U. CHI. L. REV. 299 (2007) (attempting to reconcile the inter- and intra-circuit tension surrounding the issue of ignorance of law as a defense, sparked by the *Howard* and *Monetta* decisions).

254. See *supra* Section II.A.1.

255. See, e.g., *KPMG, LLP v. SEC*, 289 F.3d 109 (D.C. Cir. 2002) (affirming that negligence is the appropriate basis for violations underlying a C&D order). But see *Howard*, 376 F.3d at 1136 (suggesting in dictum that SEC would have to use established aiding and abetting standards if it chose to predicate liability for causing violation on finding of aiding and abetting).

by the close alignment of their own self-interest and the unlawful interests of primary violators. If the interests of the parties in the unlawful scheme are viewed as being closely aligned, that might well argue for relying primarily on a standards-based regime. In such circumstances, it would be reasonable to believe that complicit secondary parties might be predisposed to engage in deliberate efforts to circumvent anti-complicity rules, and bright-line rules might be easier to circumvent than standards. Alternatively, however, if the majority of complicit secondary actors are viewed as weak-willed confederates—i.e., persons willing to accommodate the primary violator, as long as the secondary actor does not feel in imminent legal risk—then bright-line rules might prove a powerful deterrent by making not only the risk, but wrongfulness of complicit conduct more transparent to the secondary actor.

In this respect, standards may play some role in any anti-complicity regime. For example, vague standards may provide a means to sanction particularly blameworthy conduct after the fact (as a form of catchall), but vague standards alone, conditioned on a finding of blameworthiness, are not terribly effective deterrents when complicity comes in many shades and forms and the vagueness of the relevant standards makes their prospective application in many factual contexts uncertain. In other words, the inherent vagueness of anti-complicity standards based on a high degree of culpability diminishes the ability of such standards to provide *ex ante* guidance in a way that alters the behavior of the vast majority of secondary actors prospectively.

Vague standards, because of their potential for over-inclusiveness, however, may incorporate an unnecessarily high culpability bar (in contrast to context-specific rules) precisely to mitigate problems of over-inclusiveness. In other words, regulatory policy has set a high standards-based bar to avoid triggering liability excessively. Given this state of affairs, secondary actors have little incentive to internalize the standards' objectives, provided that the secondary actor can at least disclaim overt knowledge of a primary actor's violation. If this gray zone around secondary actors' conduct is sufficiently broad, standards will have only a limited deterrent effect relative to the full range of complicitous forms of behavior. As a result, vague standards which are designed to be sufficiently flexible to capture egregious forms of complicit malfeasance may ironically tolerate a greater range of complicit conduct than necessary when using precise context-specific rules. Needless to say, vague standards lacking culpability requirements do not satisfactorily solve the problem but merely create a different problem: vague standards lacking culpability requirements risk imposing significant costs by creating potential chilling effects on many forms of legitimate commercial behavior.

Standards are uniquely linked with the justification for secondary

liability in private damage actions. The very nature of the standards-based inquiry, namely the blameworthiness of the secondary actor, historically provided the basis for recovery of damages from the secondary participant based on the actor's fault. Under this view, it is more equitable to impose the risk of loss on the complicit party rather than the injured party for damages arising from the primary violation where the primary violator cannot make the injured party whole.²⁵⁶ In contrast, a rules-based anti-complicity approach is largely indifferent to the availability of private actions against secondary actors since culpable intent is not the basis of rules-based liability.²⁵⁷

Central Bank, of course, directly addressed the availability of an implied private damages remedy for aiding and abetting securities fraud violations and rejected judicial implication of such a remedy. Since then, there have been recurrent but unsuccessful legislative and academic proposals for legislatively overturning the result in *Central Bank*.²⁵⁸ If the *Central Bank* sensibility remains prevailing public policy, then that state of affairs should argue against exclusive reliance on standards-based strategies. In this respect, rules-based anti-complicity strategies may reflect a policy approach that is more consistent with a post-*Central Bank* sensibility.

Even if the private action remedy were restored,²⁵⁹ it does not follow

256. See, e.g., *Central Bank*, *supra* note 1, at 199 (Steven, J., dissenting) ("Allowing aider and abettor claims in private § 10(b) actions can hardly be said to impose unfair legal duties on those whom Congress has opted to leave unregulated . . .").

257. In some cases, private actions are expressly foreclosed for violations of rules-based obligations. See 17 C.F.R. § 243.102 (2011) (noting that failure to comply with Regulation FD disclosure requirements shall not be deemed a violation of Rule 10b-5). The absence of private remedies does not eliminate all prospects of compensation for investors, as the SEC may use the proceeds of disgorgement awards and civil penalties available to establish a Federal Account for Investor Restitution (FAIR Fund). 15 U.S.C. § 7246(a) (2006); see Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1132–33 (2008) (arguing that Fair Funds are particularly appropriate against aiders and abettors of securities fraud). But see Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 337–41 (2008) (questioning whether SEC actions for the benefit of injured investors are a suitable substitute for private litigation).

258. See *supra* notes 211, 220 and accompanying text. For an example of an academic proposal in this vein, see Mark Klock, *Improving the Culture of Ethical Behavior in the Financial Sector: Time to Expressly Provide for Private Enforcement Against Aiders and Abettors of Securities Fraud*, 116 PENN ST. L. REV. (forthcoming 2011) (proposing two suggestions for addressing the problems posed by *Central Bank*: "supplement[ing] enforcement of anti-fraud rules . . . by expressly creating a private right of action for aiding and abetting violations of securities laws . . . [and] increas[ing] financial literacy in our law schools which supply the regulators of our markets").

259. Several legislative changes since *Central Bank* relating to a private damages remedy arguably would constrain any litigation explosion upon the restoration of the private cause of action for aiding and abetting. First, Congress enacted the Private Securities

that standards should be favored over rules-based anti-complicity strategies or some form of hybrid regime. At best, restoration of private causes of action would only address complicity in the case of fraud. Although an important category, fraud-only complicity remedies understate the potential scope of a truly robust anti-complicity strategy.

Second, a damage remedy does not alter the fundamental problem of imprecision associated with an exclusively standards-based trigger for liability. While damage remedies may have an equitable justification (i.e., as between innocent investors and culpable secondary actors, losses should inure to the culpable parties),²⁶⁰ the computation of damages in practice is unlikely to be tightly correlated with any reliable measure of a particular secondary party's fault or that party's contribution to the resulting harm to investors—what Professor Langevoort refers to as the proportionality problem.²⁶¹ To the extent that correlation between third-party assistance and damages is weak, the deterrent effect of the damages award is diminished except in the strict liability sense of an inherent cost of doing business.²⁶² These concerns are arguably greater in the third party

Litigation Reform Act of 1995, which significantly limited the ability of investors to bring actions for primary violations and the potential amount of recovery against all defendants in such actions. Inability to recover from primary violators also reduces the liability exposure of secondary actors. Second, as part of the PSLRA, Congress also enacted proportional damage liability provisions, which significantly limit the potential recovery against many secondary parties in cases even where a colorable claim can be pled against a primary violator.

260. See *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 175–80 (2008) (Stevens, J., dissenting) (stating that Congress intended that federal courts ought to respect the principle that every wrong would have a remedy).

261. See Langevoort, *supra* note 229, at 2138–48 (stating that recoveries do not closely approximate actual investor injuries, and that the prevailing approach to recovery assessment overcompensates fairly significantly).

262. Several commentators have criticized the deterrence value of securities class actions generally on the basis that the resulting scheme entails welfare-diminishing compensatory payments between continuing shareholders and former shareholders and from diversified shareholders (or unlucky non-diversified shareholders) to lucky non-diversified shareholders. See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534 (2006) (positing that the incidence of penalties in securities litigation in the secondary market context should be shifted from the shareholder to the culpable parties in order to achieve optimal deterrence); Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L. J. 1 (2007) (arguing that “SFCAs” should be treated as derivative actions to avoid the problems created by the way damages are measured under current law). But see Lawrence Mitchell, *The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 291 (2009) (outlining the circularity argument but suggesting it fails because “[t]he innocent shareholder is, in fact, the irresponsible shareholder”); Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333 (2009) (arguing that damages as a remedy for securities fraud economically rewards investors who are able to identify public companies that have efficient governance mechanisms to avoid

context where the third party's liability is based on recklessness rather than knowledge because of the attenuation between the third party's recklessness and the occurrence of unlawful conduct by a primary violator. On average, awards may be accurate but there will be wide variance as to the legitimacy of the damages awarded or withheld in particular cases. These widely variant outcomes contribute to the perception of the arbitrary nature of damages in securities law cases, especially with respect to parties whose relationship to the fraud is secondary, which impose pressures for settlements that may not correspond to the underlying merits of any particular claims.

While this section has collected many of the defects of a standards-based approach, an advocate of standards-based anti-complicity approach might still argue for such an approach based on its comparative advantage relative to any alternative. If a rules-based approach were not feasible, then a standards-based regime might be preferred from a policy perspective, notwithstanding clear deficiencies. In other words, even if standards are not perfect, they may nevertheless provide the best approach. The remainder of the article seeks to show that a rules-based approach is well-suited to address complicity problems arising in the securities context because many violations are characterized by recurring patterns of conduct that could be disrupted with bright-line anti-complicity rules.

V. THE EMERGENCE OF AN INCHOATE RULES-BASED REGIME

While the use of aiding and abetting standards to deter complicit assistance directly is widely regarded as the principal model for anti-complicity policies, rules-based strategies have begun to emerge as an alternative. Like standards, rules-based strategies may seek to discourage and deter complicit behavior directly, but they may also be designed to deter or disrupt relatively passive forms of facilitation. These latter types of anti-complicity policies may seek to prohibit certain types of conduct or

securities fraud problems and this benefit will yield corresponding capital market rewards for such efficient companies). In the case of third-party liability for damages, circularity concerns are arguably attenuated because the third-party payments would not come from continuing shareholders of the public company indirectly compensating former shareholders. However, circularity concerns would still remain since it would still be likely that a public company (and indirectly its shareholders) wind up compensating former shareholders of another public company. More importantly, the relationship between the potential damages in particular cases and the third party's precautionary conduct is far less correlated than in the case of primary liability. As a result, the potential liability exposure of third parties may not provide useful price signals to third parties in selecting optimal levels of precaution. *See generally* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301 (2008) (discussing conflicting policy considerations relating to private enforcement of the securities laws, encompassing both primary and secondary liability).

practices because of the potential of such conduct or practices to facilitate primary violations by others, or they may impose affirmative duties to monitor or create systems that deter or impede primary violations, and thereby enlist the assistance of third parties in preventing primary violations. Such strategies have begun to take shape in federal securities law over the last generation, not as a coherent anti-complicity theory, but as independent initiatives aimed at plugging obvious regulatory weaknesses, principally in the area of financial reporting. This section provides a brief survey of rules-based initiatives before and after the Sarbanes-Oxley Act for two purposes: (1) to illustrate the effectiveness of such rule-based methods as anti-complicity strategies and (2) to document the emergence of such strategies as a trend precisely at a time when aiding and abetting standards have foundered.

A. *Anti-Complicity Rules Pre-SOX*

1. Accounting Books and Records and Internal Controls

The accounting books and records and internal controls provisions of the Exchange Act were enacted as part of the Foreign Corrupt Practices Act.²⁶³ While the Act is most famously regarded as prohibiting bribery of foreign officials, it included far-reaching provisions that mandated that reporting companies establish and maintain an internal accounting infrastructure.²⁶⁴ Reporting companies were required to have books and records that would permit the preparation of financial statements in accordance with GAAP, and a system of internal controls designed for that purpose.²⁶⁵ These provisions provide rules governing record-keeping and internal controls that were designed to operate within the existing disclosure and enforcement framework of the Exchange Act.²⁶⁶ While the provisions and the accompanying rules could be regarded as standards (in that they do not prescribe specific books and records and internal controls),

263. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended at 15 U.S.C. §§ 78m(b), (d)(1), (g)–(h), 78dd-1, 78dd-2, 78dd-3, 78ff (2006)).

264. See Stuart H. Deming, *The Potent and Broad-Ranging Implications of the Accounting and Record-keeping Provisions of the Foreign Corrupt Practices Act*, 96 J. CRIM. L. & CRIMINOLOGY 465, 468 (2006) (noting these provisions are far-reaching in that they are not limited to making improper payouts to foreign officials).

265. Securities and Exchange Act of 1934 § 13(b)(2)(B)(ii) (codified at 15 U.S.C. § 78m(b)(2)(B)(ii)(2006)).

266. See generally Note, *The Accounting Provisions of the Foreign Corrupt Practices Act: An Alternative Perspective on SEC Intervention in Corporate Governance*, 89 YALE L.J. 1573, 1575 (1980) (“[T]hose [FCPA] provisions were intended only to reinforce the existing disclosure framework of the Exchange Act, and that further SEC involvement in corporate affairs beyond this framework is an unauthorized and unwarranted exercise of agency discretion.”).

they do impose rules-based mandates governing procedures and accounting infrastructure for public companies in the preparation of financial statements. Although these provisions probably would not have been described as anti-complicity measures when adopted, they should nevertheless be viewed as such. By forcing company personnel to observe certain procedures in preparing financial statements, the provisions make it difficult for rogue employees to avail themselves of passive or unconscious assistance from others in subverting the company's financial reporting infrastructure.²⁶⁷ Imposing requirements for a more elaborate accounting infrastructure necessarily enlists a range of secondary participants, such as other employees and outside auditors, to become more pro-active in disrupting the unlawful activities of primary violators.

2. Enhanced Gatekeeping by Auditors under Exchange Act Section 10A

Public companies are required to provide audited financials annually in the company's Form 10K filing. While public companies require the services of an independent accountant in connection with their own filing obligations, accountability rests with the public company unless and until the auditor signs the requisite audit opinion.²⁶⁸ As part of the Private Securities Litigation Reform Act of 1995, Congress expanded the gatekeeping role of outside auditors by imposing affirmative reporting obligations on the auditor with respect to the public company's board, and if necessary, reporting obligations to the SEC.²⁶⁹ For the first time, auditors are required, in the course of their audits, to investigate potentially illegal acts and report immediately to management and the board, or audit company, those situations where an illegal act likely occurred.²⁷⁰ If the

267. Exchange Act § 13(b)(5) ("No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account . . .").

268. *United States v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984); *see also* Delphi Complaint, *supra* note 15, ¶ 57 (alleging liability for both Delphi and owner of the Consulting Company for intentionally misleading Delphi's auditor by refusing to put repurchase order in writing). For a discussion of auditors' responsibilities prior to Sarbanes-Oxley reforms, *see* Joseph I. Goldstein & Catherine Dixon, *New Teeth for the Public's Watchdog: The Expanded Role of the Independent Accountant in Detecting, Preventing, and Reporting Financial Fraud*, 44 BUS. LAW. 439 (1989) (tracing the history of auditing practices and progress of administrative response thereto).

269. PSLRA, *supra* note 7 (codified as amended at 15 U.S.C. §§ 778j-1(b)(1) & (3)(2006)) (Exchange Act § 10A(b)(1) & (3)).

270. *Id.* While the scope and nature of an auditor's duty to uncover fraud had been debatable, the enactment of the PSLRA expressly clarified this requirement. *See* Larry Catá Backer, *The Duty to Monitor: Emerging Obligations of Outside Lawyers and Auditors to Detect and Report Corporate Wrongdoing Beyond the Federal Securities Laws*, 77 ST.

company's response proves inadequate, the auditor is required to report its conclusions and either resign, and report the same to the SEC, or furnish the SEC a copy of the auditor's final report to the board.²⁷¹ The SEC is specifically authorized to institute C&D proceedings and impose civil penalties against noncompliant accountants.²⁷²

The affirmative reporting of accounting irregularities up within the organization, and if necessary, out to the SEC, represented a new type of anti-complicity provision. The traditional gatekeeping role required that auditors not assist the client firm's improper financial reporting, but did not require the auditor to take affirmative steps to reveal, and thereby disrupt, potentially unlawful conduct. The statutory mandate found in Section 10A supplanted tacit regulatory permission for voluntary, and largely silent, withdrawals by auditors in the face of potential accounting improprieties. The directives embodied in Section 10A could be viewed as both standards and rules. The standard component involves detection of illegal acts, whether material or not, while the rule component requires the auditor to take very specific steps to resolve whether the conduct was indeed unlawful and to evaluate the materiality of the conduct. The obvious intent of this provision was to require third parties to become more proactive in revealing potential securities law violations.

3. Securities Professionals

The SEC has long placed far more comprehensive restrictions on securities professionals. Because of the demands for integrity within the brokerage industry in order to have smoothly functioning markets, the SEC's oversight is far more comprehensive. Securities firms must maintain records that are subject to examination and inspection without notice.²⁷³ Aside from making primary violations less likely in the first place, these compliance devices reduce complicity in several respects. Preservation of books, records, and exams make it more difficult to obscure the trail of irregularities associated with primary violations. In a market environment where parties must rely on the financial integrity of counterparties to clear and settle trades, firms have significant incentives to detect improprieties for business and regulatory reasons. The incentive for proactive engagement is therefore perhaps more urgent than in the case of financial reporting by conventional reporting companies. The maintenance of books and records and the obligation to undergo examinations and inspections are rules-based measures that do not themselves prohibit

JOHN'S L. REV. 919, 951 (2003) (discussing auditors' monitoring obligations).

271. 15 U.S.C. §§ 778j-1(b) (2006).

272. 15 U.S.C. §§ 778j-1(d) (2006).

273. 15 U.S.C. §78(q)(a) & (b) (2006).

complicity, but nevertheless, raise the likelihood of detection of both primary violators and confederates. In addition, these measures spur firms and personnel within a firm to identify irregularities and ferret out wrongdoing. Such rules create an infrastructure that deters primary and secondary violations by causing other participants to maintain an infrastructure that facilitates detection.

The securities laws also impose a variety of requirements relating to supervision of securities professionals. Firms and supervisors are charged with responsibility for maintaining reasonable supervisory procedures and systems and enforcing those procedures. Broker-dealers and investment advisers are subject to sanction when they fail to reasonably supervise employees who commit securities law violations.²⁷⁴ Such provisions are standards-based anti-complicity measures rather than rules-based, but like rules-based measures, such as books and records provisions, they are focused on forcing participant bystanders to become more proactive in ferreting out misconduct within their organization.

B. Anti-Complicity Rules Post-SOX

When enacted, the Sarbanes-Oxley Act (SOX) represented the most sweeping reforms to the federal securities laws in over a generation, and the most significant revisions to financial reporting regulation since enactment of the securities laws in the Depression.²⁷⁵ A number of the SOX provisions ultimately effect rules-based requirements that are directed at making reporting companies and the many participants in the reporting process accountable for the integrity of, and the systems for, financial reporting.

1. Audit Committee Initiatives

The audit committee provisions in Section 301 of SOX were rules-based initiatives that reallocated responsibility for the selection and retention of the outside auditor to the public company's audit committee or equivalent governing body.²⁷⁶ This change required the audit committees of public companies to engage proactively in oversight of the company's

274. 15 U.S.C. §78o(b)(4)(E) (2006) (imposing supervisory requirements on broker-dealers under the Exchange Act), . 15 U.S.C. §80b-3(e)(6), (f) (2006) (imposing supervisory requirements on investment advisers under the Investment Advisers Act).

275. SOX, *supra* note 141 (“An Act [t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities law”); *see also* S.E.C. *Moves Quickly on Corporate Reform*, N.Y. TIMES, Oct. 17, 2002, at C12 (noting passage of the Act was “biggest overhaul of securities law since the 1930’s”).

276. SOX, *supra* note 141, t § 301 (codified at 15 U.S.C. §78j-1(m) (2006)).

audit process.²⁷⁷ The rules mandated changes that altered the composition of audit committees in terms of board members and spurred inclusion of persons of greater expertise.²⁷⁸ It also changed the dynamics of the way in which audit committees and outside auditors interact. Whereas management and outside auditors were typically regarded as jointly making reports to the audit committee to enable it to discharge an oversight function, SOX changed this dynamic. After SOX, although the outside auditor undoubtedly continued to work with management in auditing the financial statements prepared by management, the auditor reports to the audit committee, which now holds the power to hire and fire the auditor.²⁷⁹ Separate meetings with auditors and the audit committee are routine. Finally, the audit committee has access to more unfiltered information on internal complaints regarding the reliability and integrity of company accounting systems.²⁸⁰ Collectively these rules-based process initiatives create bright-line mandates for the audit committee's authority. In this way, the audit committee is compelled to take a more proactive role as a secondary participant in overseeing management's preparation of the reporting company's financial statements.

2. Audit Independence and Rotation

The audit independence and rotation provisions preclude certain forms of commercial arrangements between a public company and its independent auditor that would introduce conflicts of interest for the outside auditor.²⁸¹ In other circumstances, audit committee involvement and approval of a waiver is required, thereby ensuring knowledge and specific deliberations relating to the conflict.²⁸² Finally, audit partner rotation provisions create a bright-line rule that ensures that the audit partner for the outside auditor is changed at least every five years.²⁸³ These provisions are properly viewed as anti-complicity provisions. The enhanced independence requirements are designed to remove incentives that might otherwise lead auditors to be complicit in reporting violations or less willing to challenge management accounting judgments. The partner rotation provision is designed to disrupt complicit patterns of behavior that might be more likely to develop over time.

277. *Id.*

278. *Id.*

279. *Id.*

280. *Id.*

281. SOX, *supra* note 141, §§ 201, 206 (codified at 15 U.S.C. §§ 78j-1(g), (l) (2006)).

282. SOX, *supra* note 141, § 202 (codified at 15 U.S.C. § 78j-1(h) (2006)).

283. SOX, *supra* note 141, § 202 (codified at 15 U.S.C. § 78j-1(j) (2006)).

3. Certification and Internal Controls

SOX-mandated certification requirements make senior managers assume a higher degree of accountability for financial reporting based on information that is in their possession, and based on a statutorily-imposed obligation to assess their own company's internal controls over financial reporting.²⁸⁴ By making senior managers attest to the absence of knowledge that calls into question the truthfulness and reliability of the company's disclosure or its internal controls underlying its financial reporting, the rules-based certification requirement makes potentially passive participants in the disclosure process active participants who can no longer take a passive role in the company's public disclosure.

This form of anti-complicity measure forces senior managers to take a proactive role in financial reporting and thereby reduces the likelihood of primary violations by others. The relevant provisions make senior managers directly accountable for what they do know, or in some cases, for information that should elicit suspicion. In a sense, the measure forces senior managers to be affirmatively non-complicit, even in situations where their conduct would not entail sanctionable complicity under existing aiding and abetting and causing standards.

* * *

These rules-based examples are not meant to comprehensively list the provisions that have anti-complicity implications, but rather to illustrate two different points. First, they show that anti-complicity measures do not necessarily focus on merely addressing complicity in the narrow sense (i.e., in the sense of standards that prohibit affirmative assistance in the commission of a securities law violation). Instead, anti-complicity provisions are more usefully thought of as prophylactic measures designed to deprive or disrupt primary violators' expectations in being able to avail themselves of either knowing or unintentional passive assistance from secondary actors. Second, these examples demonstrate that rules-based measures have begun to appear in the law on a scattered and ad hoc basis. Although these measures evidence a promising alternative to a standards-based regime, they also raise the question of whether rules-based initiatives could be introduced more pervasively as a more effective means of limiting complicity in its many guises. That issue is addressed in the next section.

VI. A RULES-BASED APPROACH TO COMPLICITY

The preceding sections laid the groundwork for the proposal presented

284. SOX, *supra* note 141, § 302(a) (codified at 15 U.S.C. § 7241(a) (2006)); SOX, *supra* note 141, § 906(a) (codified at 18 U.S.C. § 1350(a) (2006)). (providing criminal penalties for failure to certify required financial reports as required by Section 302(a)).

in this section of the article. The existing standards-based regime is seriously flawed as an anti-complicity strategy. Although, as discussed in the preceding section, an inchoate rules-based anti-complicity regime has begun to take shape on an ad hoc basis, that regime is less than comprehensive. In order to overcome this deficiency, the SEC needs broader rulemaking discretion in crafting a robust rules-based anti-complicity regime. This section discusses the benefits of a more robust rules-based regime and formulates a legislative proposal that would move regulatory policy in that direction.

A. *The Virtues of a Rules-Based Approach*

While the preceding section offered examples of anti-complicity measures currently found in federal securities law, it left unstated why, as a formal matter, a rules-based strategy is likely to be effective in the securities law context.²⁸⁵ As discussed below, there are three considerations that drive the argument: first, a rules-based approach, if feasible, is likely to provide greater deterrence by providing greater guidance to secondary actors (especially third parties) regarding their conduct prospectively.²⁸⁶ Second, many securities law violations arise from recurring patterns of misconduct. Because of the recurring nature of the patterns of conduct, it may be possible to formulate bright-line anti-complicity rules to disrupt recurring forms of problematic collaborative behavior.²⁸⁷ Finally, the motivation of complicit secondary actors in many enforcement matters stems from a failure to either heed warning signs or a failure to act affirmatively in preventing assistance from being used for an

285. Approaching the issue of gatekeeper liability from a theoretical perspective, Professor Hamdani has suggested generally that regulatory rules in the securities fraud context might be a plausible policy alternative to civil damage liability for gatekeepers. Hamdani, *Gatekeeper Liability*, *supra* note 62, at 116. This result is consistent with the more detailed policy prescriptions below. Professor Hamdani also suggests selectively expanding liability in targeted areas (which he uses in the sense of liability for damages in contrast to regulatory sanctions resulting from rules). He identifies two significant conditions: (i) “a narrowly defined activity” (i.e., something that provides the gatekeeper with a high degree of clarity regarding their responsibility) and (ii) liability directed at “a party that is expected to be relatively successful in detecting issuer fraud.” *Id.* at 117–18. While undoubtedly these kinds of conditions tend to minimize extraneous compliance costs arising from liability standards, these same factors are also applicable in the context of rules that result only in regulatory sanctions. Rules are particularly useful in contextually targeting regulatory obligations, and thus, the very same considerations that lead Professor Hamdani to recommend a selective expansion of civil liability would apply with equal force in arguing for a more robust rules-based regime.

286. See *supra* Section II.A (discussing the economic and behavioral factors that support regulation of complicity).

287. See *supra* Section II.B (identifying the patterns and foundations of complicity in securities law violations).

improper purpose.²⁸⁸ As a result, rules may overcome secondary party inertia where there is at best only a weak motivation to prevent assistance from being used for an improper purpose.

The great advantage of rules is the specific prospective guidance they offer to the persons to whom they are directed. Bright lines make it easier for the affected person to align his or her conduct to the desired regulatory norm. The great disadvantage arises when persons wish to circumvent such rules. Bright-line rules are more easily circumvented because of their specificity. A regulated person who seeks to avoid the effect of applicable rules may seek out loopholes that may violate the spirit of the rule even if it does not violate its letter. If a rule is easily circumvented and persons are inclined to do so, then a rules-based regime may lead to pervasive regulatory evasion.

Standards, in contrast, are less successful in providing guidance, but tend to be more immune to circumvention. Because standards are formulated in terms of general guidance, they involve a higher degree of uncertainty as applied to specific situations and therefore may provide a less effective level of regulation. Standards may lead to uncertainty for the regulated party in at least two respects. First, the regulated persons may not appreciate that their conduct is governed by a standard because the connection between the conduct and the standard is too attenuated. Second, even where the regulated person is clear as to the potential applicability of the standard in governing his or her conduct, the party may reach the wrong conclusion as to its application in the particular factual context. These sources of uncertainty detract from the deterrent effect of standards. One need only think of the underlying facts in *Central Bank* to see why standards are frequently not very helpful prospectively. In that case, an indenture trustee failed to recognize that its decision not to seek an independent assessment of an inflated land appraisal would assist the fraudulent bond offering of a land developer.²⁸⁹ At the same time, the inherent imprecision of standards make them difficult to evade by making superficial adjustments to behavior. Invariably, standards seek to characterize the substance of the behavior regardless of its putative technical compliance with narrowly drawn rules.

Thus, the key issues in evaluating the efficacy of a rules-based anti-complicity regime is the degree to which anti-complicity rules are easily circumvented and the degree to which parties are inclined to engage in circumvention strategies. On both fronts, there are compelling reasons for concluding that anti-complicity rules in the securities law context are both

288. See *supra* Section II.C (examining the differences and relative merits of standard-based versus rule-based anti-complicity approaches).

289. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 168–69 (1994).

feasible and effective.

Financial reporting, while involving many individual judgment calls, involves a high degree of standardized procedures requiring the assistance of many different persons.²⁹⁰ Enforcement actions reveal recurrent patterns of conduct by third parties that enable materially misleading disclosure to occur. Rules directed at the role played by third parties in these recurrent patterns of misconduct would undermine the capacity of primary violators to succeed in unlawful actions, or at the very least, make success more costly or inject a higher degree of uncertainty regarding the primary violator's likelihood of success.

To have anti-complicity rules that are not easily circumvented in this context it is necessary to identify specific conduct by secondary actors that might prevent or deter recurrent violations in a broad array of situations relating, for example, to financial reporting. Secondary actors may facilitate, or at least enable, material and misleading disclosure in two respects. Secondary parties may mislead other third parties charged with verifying the reliability of the primary actor's disclosure, such as auditors and lawyers, in the audit verification letter context. In addition, secondary actors may be less than candid in sharing information with others, or withhold suspicions rather than making appropriate inquiries themselves or alerting others. Rules designed to enhance the reliability of information obtained from secondary actors and to force more sharing of candid information among secondary actors would be obvious countervailing anti-complicity strategies.

As discussed below, such rules could generate sharing among secondary actors of more company-specific information in a context beyond the control of corporate managers and provide greater prospective guidance to secondary actors regarding their legal responsibilities to act in either resolving doubts and questions or sharing reservation and concerns with others, such as gatekeepers. The rules would discourage evasive behavior, absent a higher level of deliberate cooperation from secondary actors, in the primary actor's unlawful scheme. The question is whether secondary actors are likely to want to help the primary violator when doing so would entail violating bright-line rules. The answer entails a fundamental intuition about the motivation of secondary parties. Are the secondary actors complicit by affirmative choice or as a result of behavioral circumstances? If the latter is true, bright-line rules may provide a powerful antidote. By forcing secondary actors to confront, and not to ignore, the reality of how their conduct might be enabling others to violate the securities laws, bright-line rules are a powerful and largely self-effectuating means of discouraging complicity and making primary

290. *See supra* notes 74–76 and accompanying text.

violations more difficult. Of course, bright-line rules will have a lesser impact on those who are affirmatively complicit by choice. Even in those situations, bright-line rules may make detection and punishment of such secondary participants easier, for example, if deviation from a bright-line rule is readily observable. As a result, a bright-line rule may serve as a deterrent for those who might otherwise be deliberately and unreservedly complicit.

B. A Legislative Proposal for Enabling Development of a Rules-Based Regime

Assuming at this juncture that rules have advantages over a purely standards-based regime, there remains the pragmatic issue of how such a system might be implemented. In order to fashion effective anti-complicity rules, there would need to be both considerable knowledge relating to underlying patterns of conduct and expertise in formulating rules that would disrupt the observed patterns of conduct. Such rules are more suited for design and implementation by the SEC, an administrative agency with the requisite expertise, rather than through statutory provision.²⁹¹ Nevertheless, Congress would necessarily need to be involved in fashioning an appropriate grant of rulemaking authority to the SEC.

The grant of rulemaking authority should give the SEC the role of fashioning whatever rules are reasonably designed to prevent complicit assistance, including the imposition of affirmative duties on third parties that reasonably assist in preventing violations by others and the prohibition of conduct that may facilitate others in violating the securities law. A broad grant of rulemaking authority would allow the SEC significant latitude in tailoring rules to prevent patterns of contributing conduct that emerge from their own investigations. The resulting rules should be designed to provide third parties with clear guidance to govern their conduct in specifically targeted situations. In addition, the rulemaking power should also encompass the power to fashion exemptive safe-harbors to give third parties greater certainty as to conduct that would not subject the person to aiding and abetting or causing liability. In this way, rules could be used to bring greater clarity to third parties' regulatory expectations. The accompanying text box proposes a model statutory grant

291. *Cf. Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264, 284 (2007) (finding that a grant of broad and extensive rulemaking authority to regulate securities markets impliedly repealed broad statutory antitrust prohibition); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) (rejecting in part an APA challenge to the SEC's decision to condition eligibility for exemptions, pursuant to its broad regulatory power, in order to prevent abuses of exemptive transactions).

of rulemaking authority.²⁹²

MODEL ANTI-COMPLICITY RULEMAKING AUTHORITY —

Proposed Section 20(e)(2) of the Securities and Exchange Act

2. The Commissions Rulemaking Authority to Discourage Complicity in Securities Law Violations by Third Parties

(a) IN GENERAL.—The Commission [SEC] shall, by rules and regulations, define and prescribe means reasonably designed to prevent conduct, practices, or inaction by any person that may assist, facilitate, or enable another person to violate any provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940 or the Investment Company Act of 1940 or any rules or regulations thereunder. Such rulemaking authority shall also include the power by rule or regulation to exempt certain conduct, practices, or inaction by third parties that might otherwise constitute violations of rules and regulations adopted pursuant to this section or subject such persons to sanction pursuant to Section 20(e)(1) [current Section 20 (e) as renumbered] and Section 21C of this title and related provisions pursuant to statutes administered by the Commission.

(b) STANDARDS FOR RULEMAKING.—In prescribing a rule under this provision—

(1) the SEC shall consider the potential benefits from enhanced compliance with the securities laws and the resulting benefits to investors, capital markets and the public from enhanced compliance, and the costs to persons subject to the rules or regulations in terms of additional out-of-pocket costs of compliance; and

(2) the SEC shall consult with other Federal agencies, as appropriate, prior to proposing a rule, and during the comment process regarding consistency with the objectives and policies undertaken by such agencies where any rule or regulation might affect the conduct or practices of persons already subject to regulation of such other Federal agencies.

(c) EXEMPTIVE SAFE HARBORS—

(1) IN GENERAL.—The SEC, by rule, may conditionally or

292. The language is based on rulemaking authority extended to Bureau of Consumer Affairs in the Dodd-Frank Act and existing rulemaking authority of the SEC regarding prevention of fraud. Unlike the Bureau of Affairs grant of rulemaking authority, however, this model provision requires only that the SEC consult other agencies if regulations might affect persons regulated by the other agency. The other agency's objection would not prevent the SEC final rule from taking effect.

unconditionally exempt any persons or class of persons covered by any rule adopted by the SEC pursuant to this provision, that the SEC determines necessary or appropriate to carry out the purposes and objectives of the federal securities laws, taking into consideration the factors in subparagraph (2).

(2) FACTORS.—In issuing an exemption, as permitted under subparagraph (a), the SEC shall, as appropriate, take into consideration—

- (1) business hardships that would be encountered by the class of covered persons;
- (2) the volume of transactions or services in which the class of covered persons engages; and
- (3) existing provisions of law which are applicable to the conduct or practice.

A few comments regarding this provision should be noted. First, the proposed rulemaking authority would greatly expand the power of the SEC to regulate the conduct of third parties where that conduct touches on potentially violative conduct of regulated persons, such as issuers and reporting companies. It would enable the SEC to adopt rules that directly regulate the conduct of a wide range of third parties that deal with issuers and reporting companies. Moreover, the SEC could regulate a wide range of conduct, and even impose affirmative duties on such third parties. Finally, the SEC would be able to establish the appropriate culpability standard, and if appropriate, eliminate any mental state culpability requirement.

The rulemaking authority also contains broad exemptive powers. The exemptive authority would enable the SEC to target specific conduct with greater precision without burdening third parties in an unintended fashion. Precision offers both greater clarity for those subject to regulation and reduced compliance costs for those third parties where exempt third parties would otherwise incur uneconomic compliance costs. As noted below, exemptions would not be available for knowingly providing substantial information in evading securities law requirements.²⁹³

How might this authority translate into express rules? Consider some of the examples in Section I. A recurrent pattern of misconduct by third parties concerns their willingness to mislead auditors in audit confirmation letters at the behest of the reporting company. Rules mandating more information and a higher degree of reliability embodied in some form of

293. Cf. 17 C.F.R. §230.144, Preliminary Note (2011) (establishing that “safe harbor is not available to any person with respect to any transaction or series of transactions that, although in technical compliance with Rule 144, is part of a plan or scheme to evade the registration requirements of the Act”).

certification rule would not be easily circumvented. The certification could require different levels and kinds of information. The certification could take the form of a negative assurance that the person providing the certification has no knowledge of certain types of facts. The certification could seek new information, such as the most knowledgeable individuals at the third party company regarding the transaction and require a certification from that person. The certification could require summary disclosure of communications between the third party and the reporting company relating to the accounting treatment of the transaction. Finally, the certification could be required to contain a legend alerting each signatory that material misstatements in the certification will subject the signatory to sanction under federal securities law.

Another area of recurrent problems has been end-of-quarter transactions. A firm could be forced to identify certain end-of-quarter transactions based on timing, size, or unusual nature (i.e., transactions not in the ordinary course of business). In some contexts, certification requirements could be imposed, while in others, auditors or outside counsel could be required to conduct additional verification by means of an independent interview with the reporting company's counterparty regarding the purpose and underlying facts of the transactions.

In the Delphi matter,²⁹⁴ such a requirement would have subjected the bank to potential liability, assuming it still went through with the transaction and signed the requisite certification without reservation. The independent auditors would have been required to review the certification and might have focused on the end-of-quarter transactions more carefully. Another rule might establish a safe harbor for companies providing counterparty certifications to public companies. The safe harbor would require internal procedures to detect anomalous transactions; absent such procedures, companies such as the IT company or the bank could be sanctioned for the complicit conduct of their employees. Even if outside auditors were not required to review the certifications, a false certification would subject the certifying party to sanctions. Obviously, the result obtained in the Apuzzo matter would likely be different; Apuzzo would have been required to provide a letter and the execution of a false certification alone would be sufficient to subject the certifying party to sanctions.²⁹⁵

Anti-complicity rules could be used to regulate derivative transactions of derivative dealers to prevent apparent sham transactions. In the aftermath of Enron, something along these lines was actually suggested, but never implemented. Following the conclusion of SEC enforcement

294. See *supra* notes 15–38 and accompanying text.

295. See *supra* notes 48–52 and accompanying text.

proceedings brought against several investment banks,²⁹⁶ an interagency report urged financial institutions to adopt internal procedures providing greater scrutiny and review of complex structured finance transactions designed primarily “to achieve financial reporting or complex tax objectives”²⁹⁷ While the Interagency Policy Statement merely sought to provide guidance regarding best practices, the statement could have served as the blueprint for prescriptive rules to shape institutional behavior. Of course, this is not what transpired. Instead, in the face of intense industry criticism, the thrust of the original statement was significantly weakened in a revised proposal and subsequent final statement that veered away from bright-line rules designed to foster pro-active anti-complicity responses in favor of vague self-enforced standards.²⁹⁸ The final advisory statement, by merely suggesting adoption of modest prudential procedures and not requiring pro-active anti-complicity procedures, illustrates the failure of regulators to embrace rules-based strategies that could otherwise prove extremely effective.

296. *See supra* note 88 and accompanying text.

297. Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28,980, 28,988 (May 19, 2004). While the specific guidelines identified circumstances to consider to determine whether “additional scrutiny” was needed, the Statement’s final sentence left little doubt regarding the agencies’ aspirations for affirmative action by financial institutions: “The regulatory agencies expect financial institutions involved in structured finance transactions to build and implement enhanced risk management and internal controls systems that effectively ensure compliance with the law and control the risks associated with complex structured finance transactions.” *Id.* at 28,990.

298. Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 71 Fed. Reg. 28,326 (May 16, 2006) (presenting a revised proposed interagency statement); Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 72 Fed. Reg. 1372 (Jan. 11, 2007) (providing its final statement). The revised proposal and final statement replaced assertive language in the proposed statement with extensive qualifications. For example, the revisions carefully noted that the statement did not “alter or expand legal duties and obligations” of financial institutions, and explicitly disclaimed compelling any specific response on the part of financial institutions when elevated legal risks were detected. In a key paragraph of the Final Statement, financial institutions are urged to “take appropriate steps” only if the financial institution “determines that its participation” in the transaction “would create significant legal . . . risk for the institution” and such appropriate steps did not require “declining to participate in the transaction” but could merely require conditioning participation on the receipt of reasonable “representations or assurances from the customer.” 72 Fed. Reg. 1372, 1374. The Statement does concede that institutions “should decline to participate in elevated risk” transactions, but such a norm is operative only if after taking steps such as obtaining representations or assurances from the client, “the institution determines that the transaction . . . would result in a violation of applicable laws, regulations or accounting principles.” *Id.* at 1375. In other words, only if it affirmatively determines there would be a violation of law—a very generous threshold in tolerating a significant degree of complicity.

C. The Continued Importance of Standards

While this article has argued that a rules-based regime would lead to more efficient anti-complicity policies, it does not recommend eliminating anti-complicity standards, such as aiding and abetting principles or causing liability. Such standards provide a powerful and necessary backstop to the inevitable gaps and interstices of a rules-based regime. As noted, the potential weakness of rules is the risk of circumvention. Backstop standards are useful in defeating deliberate efforts to circumvent anti-complicity rules and anti-complicity coverage where no rule can be readily fashioned to address the problematic conduct or practice.

Backstop standards have another useful purpose because they provide assurance to regulators in fashioning exemptive rules that prevent third parties from exploiting regulatory gaps. The SEC commonly uses conditions prohibiting use of an exemptive rule to commit fraud or a knowing evasion of regulatory policy to curb misuse of an exemption, conditions that are admittedly inherently standards-based. Backstop standards in this context actually encourage agencies like the SEC to be more willing in granting exemptions, knowing that the agency will still have the ability to police egregious misconduct.

A potentially constructive by-product of specific anti-complicity rules is that they may make existing anti-complicity standards more effective. As noted, a significant purpose of anti-complicity rules would be to increase the flow of reliable information among third parties. If secondary parties have access to more information, then their ability to disclaim knowledge of how their conduct may be assisting in unlawful conduct is diminished.²⁹⁹ In short, rules that require greater direct sharing of information among secondary parties may either discourage some conduct and practices currently performed by secondary parties, or make it easier to challenge those activities under existing anti-complicity standards.

CONCLUSION

Many types of securities law violations depend on the assistance secondary participants provide to primary violators. Effective anti-

299. This point is illustrated by a recent enforcement action brought by the SEC (although the matter itself has not been adjudicated) in which the SEC alleged that the outside directors who served on the reporting company's audit committee facilitated egregious accounting and reporting improprieties by turning a blind eye to numerous red flags. DHB Indus., Litigation Release No. 21867, 2011 WL 700536 (Feb. 28, 2011); Complaint, SEC v. Krantz et al., Civil Action No.0:11-cv-60432-WPD (S.D.Fla. 2011). This matter was subsequently settled with the defendant independent directors agreeing to pay monetary sanctions amounting to \$1.6 million. See SEC v. Jerome Krantz, et al., SEC Litigation Release No. 22154 (Nov. 15, 2011).

complicity policies present a powerful means to enhance securities law compliance by depriving primary actors of the assistance that they need in order to commit more serious securities law violations. Currently, aiding and abetting standards serve as the primary means for regulating culpable assistance by secondary actors, but these standards are imprecise and their meanings turn heavily on fact-bound applications of the standards. As such, although the standards may adequately address extreme forms of misconduct, they do not provide significant prospective guidance to secondary actors or deal effectively with recurrent factual scenarios where preventing assistance would significantly enhance compliance. Legislators and regulators have overlooked the benefits of rules-based regimes as an alternative means of advancing anti-complicity policies. Such a rules-based regime could be implemented through a grant of broad rulemaking authority to the SEC to craft anti-complicity rules. These rules would not entirely displace existing standards, but rather would allow regulators to target secondary actors and the conduct that contributes to violations. Rules would enable regulators in some cases to discourage problematic conduct and, in other cases, to enlist the assistance of secondary actors in preventing securities law violations. In either case, they would provide secondary actors with prospective guidance regarding their assistance to others. Anti-complicity standards would continue to perform an important supplementary purpose, namely to address instances of knowing or reckless complicity, egregious efforts to circumvent anti-complicity rules, or to provide a backstop in circumstances not addressed by rules.